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Asset Allocation Is Broken

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Traditional asset allocation – the idea that you don't put all your eggs in one basket – subjected investors to large losses from 2000 to 2002, again in 2008 and at times over the past couple of years. The model is broken, but it can be fixed.

The definition of insanity is doing the same thing over and over, and expecting different results. By that definition, investors who continue to follow a traditional asset allocation approach are insane.

The main problem with traditional asset allocation theories is that portfolios are generally heavily weighted toward stock investments that are held regardless of market direction. Over very long periods, stocks traditionally did well. Yet there were times that stock investors suffered large losses that took years or decades to recover from.

For example, stock markets hit a peak in October 2007, and almost five years later we are nowhere near that high. Asset allocation advocates point out that they also add things like bonds to a portfolio to reduce risk. But since bonds are much less volatile than stocks, the risk reduction is often much less than investors realize—often after it is too late.

The Problem With the Balanced Portfolio

The traditional balanced portfolio often recommended to investors is 60% stocks and 40% bonds. The idea is that the stocks will provide solid returns and the bonds will reduce the risk of the overall portfolio.

However, in real life this doesn't work out as planned. Assume a portfolio made up of 60% in the **SPDR S&P 500**(SPY) exchange-traded fund, representing stocks, and 40% in the **iShares Barclays Aggregate Bond** (AGG) ETF, for bonds.

In 2008, the SPY returned negative 36.7%, and the AGG, 7.56%. The overall portfolio returned negative 19%. This was certainly better than the return of the Standard & Poor's 500 stock index (minus 37%), but a 19% loss is still unacceptable.

Why didn't the bonds protect the portfolio more? Because looking at the standard deviation (a measure of volatility) of each ETF, the SPY is five times more volatile than the AGG. So while the overall portfolio only has a 60% allocation to stocks, stocks comprise much more than 60% of the overall risk of the portfolio.

Risk Parity: A Better Approach

Risk parity is the idea of weighting assets or strategies in a portfolio by the risk that they add. In our example above, to equalize the risk of the SPY and AGG, we allocate 84% to the AGG and 16% to the SPY. This portfolio would have been up 0.48% in 2008, which investors no doubt would have welcomed.

Still, it is probably unrealistic for most as it would lag significantly during up years. Institutional investors have gotten around this problem by using leverage. Using borrowed money they can go beyond 100% and create attractive risk parity portfolios. That approach, though, is not practical for individual investors.

Combining Risk Parity and Tactical Asset Allocation

With tactical asset allocation (TAA), you change the mix of your assets based on their price performance. You favor asset classes that are in an uptrend, and exit those in a downtrend. This significantly alters the risk versus reward spectrum, lowering risk and increasing returns, making TAA strategies a perfect combination with risk parity. Unlike buy and hold, which just keeps a certain asset class regardless of its direction, TAA stays in harmony with market movements.

As a simplified example, let's combine two tactical strategies and weight them by risk.

Strategy 1 is a diversified basket of stock and bond ETFs, plus index funds. Every week, we use our proprietary tactical systems to choose the one strongest area. Strategy 2 is a diversified basket of bond ETFs and index funds. Every month, our proprietary tactical systems help us choose the two strongest areas.

Weighting these strategies by risk puts 42% in Strategy 1 and 58% in Strategy 2. In 2008, this mix was up 45.3% (this is because both strategies moved into Treasury bonds) and up 17.13% in 2009, the recovery year. (Returns do not include fees, commissions, taxes, etc.)

Risk parity fixed a lot of what is wrong with traditional asset allocation. It is currently very popular among institutional investors, where most ideas start out before they filter down to individual investors. Over the next decade, this will become the generally accepted approach to allocating among different asset classes and strategies.

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