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Asset Allocation – Another Look

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How investors divide their investments between stocks and bonds (referred to as asset allocation) is one of the most important investment decisions. But even though it is often discussed with precision, the "right" mix for most investors is as much an art as it is a science.

One reason asset allocation is so fundamental is that traditionally the risks and returns associated with stocks versus bonds are very different. Over the long-term, stocks have given investors better returns than bonds, but with much more risk. Stocks have increased a little more that ten percent a year over the past century while bonds had returns of around 5-6 percent.

Stocks are riskier than bonds because they bounce all over the place - up strongly for a while and periodically dropping like a stone. Even though their long run annualized return is about 10 percent, they seldom go up ten percent in any particular year. Sometimes they are up 20 percent and other years are down 20 percent. This dispersion of results is called volatility and since the returns of stocks vary widely they are said to have "high volatility."

One confusing point is that volatility is often associated with risk - assets with high volatility are called "high risk." It is easy to see why stocks are high risk if they fall 20 percent, but why are they high risk when they go up 25 percent? One way to think about volatility is it is the chance an investor might have to sell stocks when they are way down and the risk that they might buy stocks when with are way up. In hindsight, we know that investors who bought the Dow Jones in 2001 paid too much and just got back to even a few weeks ago. Investors who invested in the NASDAQ 100 at that same time are still down 50 percent.

Diversification is one of the important principals of asset allocation. It advises that you should split investments between stocks and bonds and not "put all you [nest] eggs in one basket."

So how do investors decide how much to invest in stocks and how much in bonds? Most financial planners and publications basically tell investors to split their investments based on their age. When they are young they should put 80-90% into stocks and the remainder in bonds. As they age, less should be in stocks and more should gravitate to bonds. In general this is good advice. The really tricky part comes when investors are in their 60s

and 70s. I believe better asset allocation decisions will be made if a person's wealth and spending patterns are also taken into account.

Since stocks have better returns but are more risky, AKA "volatile," - as a rule of thumb, only money not needed for the next 10 years should be invested in them. The corollary is that all the money an investor might need from their savings in the next 10 years should be in bonds.

If a 65 year-old retiree has $50,000 saved and thinks they might need that to supplement social security in the next 10 years, most, if not all of it should be invested in bonds. Although in theory, it would be nice to invest in higher returning stocks, the risk is too great.

On the other hand, another investor with $50,000, who thinks his pension plan and social security will cover his spending, can afford to take more risks and invest maybe 60 or 70 percent of their savings in stocks.

Now let's look at this from the perspective of a 65 year-old retiree who has decided to use a new popular strategy. This strategy theorizes an investor can withdraw 4.5 percent of their savings in the first year; increase that dollar amount by inflation each year and not run out of money for about 30 years.

For an example, assume inflation is 2.5 percent and after-tax returns in stocks and bonds are 7.0 and 3.5 percent respectively. Using the above strategy and my plan for asset allocation, what should his stock/bond allocation look like? By planning to withdraw 4.5 percent per year, in the next ten years the total withdrawal before inflation comes to 45% of his current portfolio. Therefore, at age 65 his asset allocation should be 55 percent stocks and 45 percent bonds.

After 5 years, at age 70, his withdrawal rate will be 4.9 percent of his remaining savings and his stock/bond allocation would now be 51/49. By age 80, the withdrawal rate of 6.6 percent implies a 34/66 split. When this retiree reaches 87 his allocation would move to 100 percent bonds and he would deplete his assets at age 96.

One short-cut - if you plan on a steady withdrawal rate, your bond allocation should be 10 times the percentage rate of your withdrawal. In other words if you are taking out 2% this year, your asset allocation should be 80 percent stocks and 20 percent bonds. Withdrawing 7 percent results in 30/70 allocation.

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