Worthy Planning Insights

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The Evolution of Modern Asset Allocation to Minimize Risk of Loss Without Compromising Opportunity

by

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> *"I will tell you how to become rich. Close the doors.*
> *Be fearful when others are greedy.*
> *Be greedy when others are fearful."* - Warren Buffett

The Goal of Every Investor

Almost anyone who invests knows this famous quote from the most renowned long term investor of our time. The notoriety of the quote stems from its focus on the emotions of fear and greed. Surprisingly less is made of the first sentence, "I will tell you how to become rich." After all isn't that the goal of every investor - to either "*get*" rich or "*stay*" rich?

Whether you are (a) an individual investor or advisor trying to double your money, or you are (b) a single or multi-family office client or professional responsible for stewarding 100 million dollars or more - or anywhere in between - how you look at the opportunity to grow your portfolio can be very different. Most often Investor (a) is looking primarily for a return *on* his capital, while Investor (b) is looking to make sure he can sleep well at night knowing he can get a return *of* his capital when he wants or needs it.

2 Decades, 3 Bubbles?

The current bull market was born on or about March 9, 2009.[1] Now in its 10th year, it is one of the longest bull markets on record as measured by the S&P 500, up approximately 3 times the value of where it began, and well above the average bull market duration and return on record going back over 70 years.[2] Given lessons learned from investor experiences at the end of the tech bubble in 2000-2002, and the disastrous securitization of subprime mortgages that led to the Great Recession of 2008-2009, is it possible we are experiencing yet another bubble and what does this mean for investors today?

[1] See *The Bull's Final Countdown: How to Prepare*, Barron's, July 2, 2018.
[2] See Table 1 on next page.

Table 1:

Trough	Peak	Gain	No. of Days
10/9/46	6/15/48	20.8%	615
6/13/49	8/2/56	267.1	2607
10/22/57	12/12/61	86.4	1512
6/26/62	2/9/66	79.8	1324
10/7/66	11/29/68	48.0	784
5/26/70	1/11/73	73.5	961
10/3/74	11/28/80	125.6	2248
8/12/82	8/25/87	228.8	1839
12/4/87	3/24/00	582.1	4494
10/9/02	10/9/07	101.5	1826
Average		161.4	1821
3/9/09	**?**	**301.8**	**3400***

Number of days includes weekends and holidays. *Through 6/29/18
Sources: Barron's; Yardeni Research; Bloomberg

Regardless of your opinion of where we are right now in the latest cycle, given the recent return of volatility normally characteristic of equity markets, coupled with the Federal Reserve's policy of increases in short term interest rates after years of qualitative easing policies, investors might be well served to engage in a serious analysis of their current portfolio. The historic magnitude of this current bull market provides a very significant investment planning opportunity for each investor to investigate more attractive and potentially less volatile opportunities out there, before determining what the best course of action is to either "*get*" or "*stay*" rich from here.

This *Worthy Planning Insight* is the first of a two-part series designed to:

a. Help investors better understand how they got to where many are today by examining briefly the historical evolution of modern portfolio theory;

b. Compare earlier models of diversification from diversified portfolios today, and provide comment on why they have done so well until now, as well as their effectiveness and predictability to do the job going forward; and

c. Suggest that there is a better way to best meet the investment goal of either "*getting*" or *"staying"* rich going forward[3]

[3] We do not address taxes or tax efficiency in this article. It goes without saying that tax efficient investing through tax-advantaged structures and by managing assets in a tax sensitive manner in taxable accounts is incredibly important, but not the focus of this article, which is on asset allocation and investment planning.

The Beginning of Modern Investment History: The Migration From Commissioned Brokers to Managed Accounts Based on Modern Portfolio Theory

For most of the 20th century history of the US stock and bond markets, brokers and the large wire houses promoted the investment of capital into both equity and fixed income markets.[4] These brokers dominated the private investment scene and were for many investors their sole access to participation in these markets.[5] In these early years there was perhaps little if any concern over the concept of asset allocation. Rather there were just assets thought to be risk free, such as US Treasuries and cash, and riskier assets that Wall Street was all too happy to trade by buying and selling to investors, receiving large commissions in return.[6]

The investing world was influenced by a 1952 article by Harry Markowitz published in the *Journal of Finance* recognizing that by combining assets whose returns are not highly correlated, an investor could reduce his or her investment risk without reducing expected returns.[7] According to Markowitz, it is theoretically possible to construct a portfolio of risky assets with the smallest amount of risk for a given return.[8] This theory became known as Modern Portfolio Theory[9] and was subsequently expanded in the late 1950s and 1960s by academics such as Tobin and Sharpe, such that it formalized the return and risk relationship between securities in what is known today as the mathematics of diversification.[10] The ability to estimate what the future returns and risks of a range of an investor's acceptable investments are, and to choose a course of action based on those alternatives, became the very heart of what we know today as "asset allocation,"[11] and has dominated the world of finance for over 50 years.[12]

The Widely Accepted Use of the 60/40 Balanced Portfolio

From Modern Portfolio Theory developed the idea of the "balanced account," which for many investors, generally consisted of a mix of 60% stocks and 40% bonds. This balanced account approach became widely utilized by investors and advisors in the 1980s and 1990s.[13]

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[4] In the "old world," brokers, as members and owners, controlled the exchanges. Exchanges had a monopoly on liquidity, and brokers controlled access. Cappon, The Brokerage World is Changing, Forbes, April 16, 2014.

[5] Ibid.

[6] Jones, *A Century of Stock Market Liquidity and Trading Costs*, Columbia University Graduate School of Business, Updated May 2002.

[7] Kintzel, *Portfolio Theory, Life-Cycle Investing and Retirement Income*, Social Security Administration Office of Policy Brief 2007-002 (released October 2007).

[8] Ibid.

[9] It is important to note that Modern Portfolio Theory (MPT) today is over 65 years old. As such, MPT might better be referred to as IPT (Initial Portfolio Theory) or OPT (Old Portfolio Theory). Thomas Schneeweis, *The New Science of Asset Allocation: Risk Management in a Multi-Asset World* (John Wiley & Sons, January 2010), p. 6.

[10] Ibid.

[11] Ibid. There are 2 fundamental directives of asset allocation: (1) Estimate what may happen in the future and (2) choose a course of action based on those estimates.

[12] Ibid., p.4.

[13] E. Denby Brandon and H. Oliver Welch, *The History of Financial Planning: The Transformation of Financial Services* (John Wiley & Sons, 2013), p.132

The idea behind this approach was based on data that the tendency of stocks and bonds, especially high quality bonds, to move up or down was not closely related to each other but was due to different factors. For example, the direction of stocks was based more on earnings, profits and consumer sentiment, and of bonds was based more on current interest rates, credit quality and liquidity. For the very reason that stocks and bonds tended to move directionally based on different factors, the data suggested that in many of the more volatile periods, where stocks went down bonds provided stability to a portfolio by going up, staying flat or going down significantly less than more volatile stocks. One of the reasons for this may have been that when stocks went down, investors often purchased bonds, especially high quality bonds. Therefore the 60/40 balanced portfolio was relied on by investors and advisors alike to exhibit smoother returns over the long run with significantly less downside risk because of the protection bonds typically afforded when equity markets went down significantly.

The Evolution from Modern Portfolio Theory to Multi-Asset Class Allocations in a Supposed "New Normal" World

The Great Recession of 2008 seriously challenged and in many ways changed investor and advisor sentiment about the benefits of a 60/40 balanced portfolio, since in this particular liquidity crisis, virtually all asset classes sold off and lost value. This included even those high quality municipal and taxable bonds that had been the ballast of balanced portfolios, along with some other asset classes designed to protect their portfolios, such as alternative investment hedge funds, which during the crisis were sold in a flight to even higher perceived quality, such as cash and short term US Treasuries.[14] Seeing double digit losses within just weeks in the perceived to be safest part of their portfolio was enough to have some advisors and investors flee these previously-thought to be safe fixed income investments along with the more volatile equities many were frantically selling. Classical balanced investing as a long term solution was soon to be replaced, or at least modified, in favor of something else. It was not long before many began to call this something else a "new normal" investment world.[15]

Perhaps surprising to some, the new normal approach continued to embrace the much-adhered-to principles of modern portfolio theory and diversification. Some advisors and their firms, I suspect, merely added additional categories of sub-asset classes to their beaten balanced portfolios, further diversifying them within the broad asset categories they had relied on before. Table 2 on the next page shows what I believe to be a typical sample of a pre-2008 crisis balanced portfolio in the left hand-column, as well what I believe to be a typical sample of a more diversified New Normal portfolio that emerged post-crisis on the right hand side. Going back to Markowitz's theory as expanded by others, it was expected that if a client or his advisor increased the diversification in such a manner, the less risky the portfolio was overall. Further, advisors believed from both their training and experience that because of the increased diversification, the more likely the client would better be able to stay with their long-term

[14] Michael Brandl, *Money, Banking, Financial Markets and Institutions*. Cengage Learning, January 2016.

[15] "New normal" is a term still used today but originally coined during the financial crisis of 2008 by PIMCO Co-CIO Mohamed El-Arian and better known bond guru and then Co-CIO Bill Gross. The term was used to describe the current investment landscape and to describe why PIMCO was launching a global diversified fund to provide solid returns and to protect investors against severe market downturns in the future. See Steven Goldberg's "What 'New-Normal?': El-Arian's PIMCO Fund Falls Flat," Kiplinger's, November 14, 2013.

investment plan during the next turbulent markets, and not blame the advisor as much during periods of extreme market volatility.

Table 2:

Sample Classical Balanced Asset Allocation Aug. 2008	Sample New Normal Asset Allocation
Equities: 58% US Equities 38% ------------------------→ Developed International 15% ----------→ Emerging Markets 5% ------------------→	**Equities: 51%** US Equities 35% **(25% Large Cap, 10% Small/Mid Cap)**[16] Developed International 10% Emerging Markets 6%
Fixed Income: 30% US Investment Grade Bonds 27% ----→ US High Yield Bonds 3% --------------→	**Fixed Income: 34%** US Investment Grade Bonds 9% US High Yield Bonds 8% **International Fixed Income 8%** **European High Yield 9%**
Alternatives: 13 % REITS 5% -------------------------------→ Other 8% (1-3 categories) -------------→	**Alternatives: 15 %** REITS 3% **Other 12% (Up to 5+ categories)**

Where Many Investors Have Settled:
Strategic Long Term Diversification with Tactical Asset Allocation

> *"Wide diversification is only required when investors do not understand what they are doing."* - Warren Buffett, again

[16] The maize bold colors in column two depicting the "New Normal" Asset Allocation illustrates new asset classes added and examples of how advisors and asset managers may have increased investor diversification post-crisis.

Looking at each of the depicted allocations on Table 2, you won't find many differences. It's not easy to abruptly change philosophies or habits, especially if you have little or no conviction to do so. People who smoke have a tough time quitting cold turkey and doing something else. Similarly, what I observed after 2008 was that investment advisors who had advised their clients to invest in balanced stock and bond accounts based on Modern Portfolio Theory before the crisis were not about to abandon those strategies entirely, and advisors invested their clients in even more asset classes, or sub-asset classes under the broader categories of stocks, bonds and alternatives.[17] This was a continuation of the idea going back to Markowitz and those that followed him that more diversification was better. The more asset classes you invested in, the thinking went, the better protected you would be. And by setting a "strategic" long term allocation, you could make short term "tactical" changes along the way based on price fluctuations in other asset classes - hopefully buying low and selling high - to lock in some gains and return to the portfolio. This type of change was a natural extension of modern portfolio theory, keeping the core of the balanced approach, and augmenting it with the ability to diversify between more asset classes. As a practical matter, employing such strategies, even by only making changes in small amounts, was evidence for both the client and the advisor that the portfolio was being actively managed versus being ignored.

So what happens now - and has continued for much of the past decade - is that the person responsible for managing the portfolio today usually forms some macroeconomic world view that helps him decide what the relationship of all the different diversified components should be.[18] For example, the advisor or his firm's strategist or CIO may have an opinion as to how attractive US stocks are and predicts where they will be, compared to international stocks, and whether emerging markets are fairly valued; or which fixed income investment will have a better total after-tax return, municipal bonds or corporate high yield bonds? Should the portfolio contain REITs (Real Estate Investment Trusts), gold, managed futures or any other number of asset classes from treasuries to timber? And what form should the client own individual securities or commingled low cost vehicles, such as ETFs?

Based again on my experiences, such a portfolio looks something like the one in the right column of Table 2 on page 5, where the investor or their advisor typically has a general strategic long term allocation of say 45-55% equities, 30-50% fixed income and 0-20% alternatives. And what happens periodically (sometimes month to month or quarter to quarter), the advisor buys and sells 1-5% here and there between the listed sub-asset classes. For example, within the category of equities, the changes might be made between US and international stocks, or in fixed income, between corporate high grade bonds and high yield, lower grade bonds. The changes can also be made between the broader categories such as by moving fixed income to equities, or vice versa.

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[17] Based on my experiences at the time, I think there were two main reasons for this. First, the advisor could not tell their client that their advice was somehow wrong before. Second, even if the advisor wanted to make drastic changes to the portfolio to some new strategy, the client more than likely would not have let their advisor make all those changes for several reasons, not the least of which was wanting their losses to come back to their former high, i.e. in their minds - getting back to even.

[18] Harold Kent Baker and Greg Filbeck, *Portfolio Theory and Management* (New York: Oxford University Press, 2013), Ch. 13 - Overview of Asset Allocation after 2008.

It is this author's contention that this approach is really at its core a "feel good" exercise that investors and advisors are very fortunate has worked well in this nearly decade long bull market. Ironically, investors and their advisors seem to have felt safer, better and more in control of protecting the portfolio from another severe decline by merely toggling numbers in this way, usually between columns in an excel spreadsheet or on a quarterly review page. The investor or advisor may or may not have a disciplined and effective process to make these changes he is recommending.

Even in this reality, for many investors, the investment results of staying in the market with a significant allocation to equities has worked out beyond anything the investor or advisor could have possibly imagined. (See Table 1: The S&P is up over 300%). In spite of these gains, it would be difficult to argue that the positive results came primarily as a result of decisions made within the portfolio itself since typically when a manager likes an asset class, or dislikes another, he limits the overweight or underweight to a maximum 10% overweight to the favored asset class or underweight to the disliked asset class.[19] For many investors and advisors, this new normal approach is essentially an admission that the person making the investment decisions has no strong conviction one way or the other about any asset class or group of asset classes he or she owns on behalf of clients. Fortunately for most investors in this new normal world, anyone employing this strategy has been luckier than smart by default since nearly every single asset class but cash has been up since March 2009, and with very little volatility until just recently.[20] *See* Table 3 on the next page.

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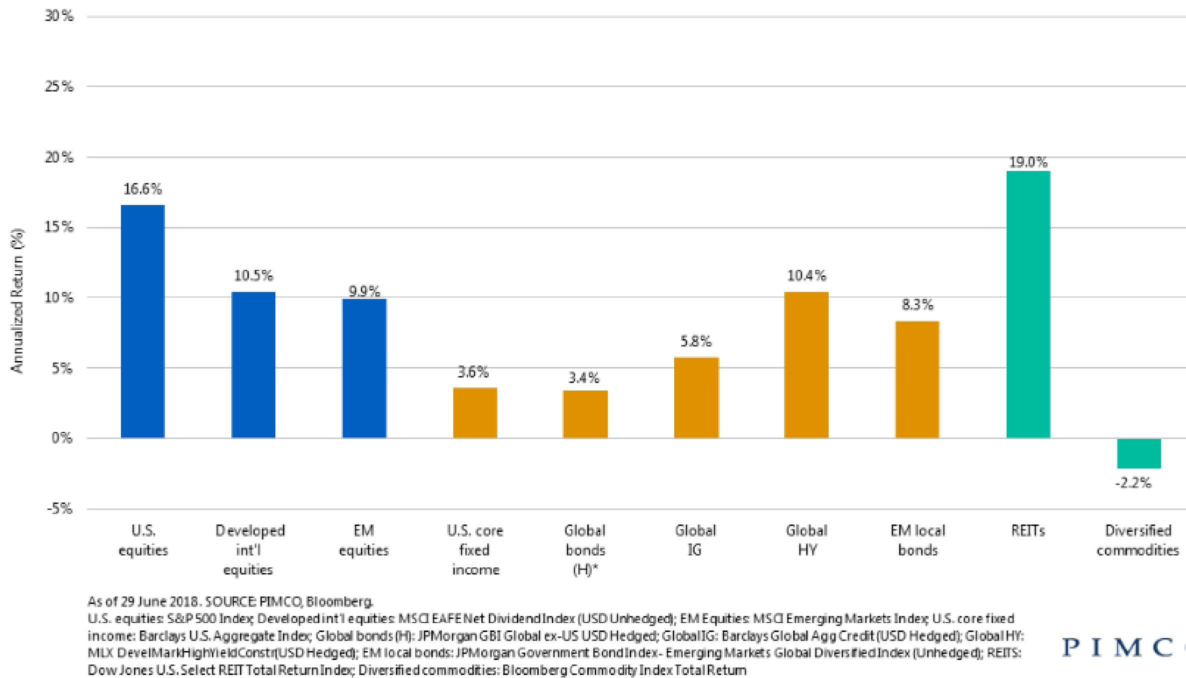
[19] See "JP Morgan model portfolios available in LPL Financial Model Wealth Portfolios Program [MWP]: Global Asset Allocation models and Diversified Absolute Return model" KPwealth, December 2011, accessed July 17, 2018, http://www.kpwealth.com/wp-content/uploads/2012/02/JP-Morgan.pdf stating "JPMIM will take smaller positions in the more conservative portfolios and larger positions in the more aggressive models. The maximum position size is typically a 10% over- or underweight to equities versus our long-term strategic asset allocations."

[20] See Table 3. Source Pimco Smart Charts, "Asset Class Returns Since March 2009," Smart Charts in Focus, June 29, 2018, accessed July 17, 2018, https://www.pimco.com/en-us/resources/smartcharts, showing asset class returns since March 2009 and how everything has been up except for diversified commodities.

Table 3:



Asset Class Returns Since March 2009

Since the bottom of the crisis, most asset classes have recovered

EQUITIES FIXED INCOME ASSET ALLOCATION

Conclusion

Now what? Does anyone think toggling 1%, 3%, 5%, or even in stages up to 10% between column A and B on a spreadsheet is going to protect a client from losing a lot of money in a down market, let alone "*keep*" that client rich? Or, on the other side of the coin, can toggling a few or several percentage points here or there help someone "*get*" rich? The answer is a common sense, clear and resounding: No. In my opinion, it is time – it's actually been time for quite a while – for investors and advisors to stop toggling numbers on a computer or spreadsheet and to employ a significantly different and far more impactful strategy.

Investors and advisors can and should make a significant strategic change now to their portfolios to have the best chance of meeting their investment goals. Just because it has worked well for them for the past decade, when nearly every asset class has appreciated, does not mean they should keep the same long term strategic allocation and continue to make the same small changes here and there. Merely toggling an investment portfolio a little bit here and there will likely neither provide significant net contributions to return, nor protect a portfolio enough as volatility returns to normal and in anticipation of the next time markets head into stormy waters. With publicly traded equities, bonds and even some and some direct real estate at or near historic highs, there seem to be fewer and fewer choices of discounted asset classes or opportunities to

invest. Investors and advisors could be very well served to engage in a formal review of what they own, and then research and compare other investment alternatives with better risk return characteristics, valuations, liquidity and other financial considerations. If they can find other alternatives that check most of those boxes, perhaps they should make more meaningful allocations to those opportunities to help "get" or "stay" rich from here.

Your questions, comments and requests for further discussion are thoroughly welcomed by mail to ematheson@worthventure.com or in person by calling me directly at 1-212-558-9017.

Eric Joseph Matheson is the Director of Family Office Services for Worth Venture Partners. He brings over 25 years' multidisciplinary experience as a business and estate planning lawyer, trustee, investment planning strategist and family advisor to both US and non-US ultra-high net worth individuals, and their families, trusts, corporations, partnerships, foundations, and family office groups. At Worth Venture Partners, Eric works with qualified individual investors, family office and institutional clients to ascertain their unique needs and provide them with customized alternative investment solutions that fit those needs.

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