The Rennie Quarterly Return

Rennie & Associates
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Asset Allocation

Asset allocation is easy. An investor should simply select the best-performing asset class, stocks, bonds, real estate, etc., over the coming year and plunk down their entire portfolio. After the first successful year, consult one's crystal ball, and reallocate.

Unfortunately, predicting next year's best-performing asset class is impossible, and the top-performing this year may be the worst next year.

Three key factors drive portfolio returns; asset allocation, security selection, and investment timing. Studies have shown that of the three, asset allocation is the single most important determinant of the variance in portfolio returns.

A well worn adage states "don't put all of your eggs in one basket." Asset allocation applies the same principle to investing, by spreading a portfolio across asset classes so that in any given year those that underperform will be offset by those that outperform.

Our clients know that we spend a significant amount of time discussing risk tolerance at initial meetings, and over the course of our relationship. Risk tolerance, along with a client's financial profile and objectives, determines the appropriate asset allocation for each client.

Correlation

The weaker the tendency of two asset classes to move in tandem, the greater the risk reduction achieved by owning them in combination. A statistical measure of this tendency is correlation. The table below shows the correlations between four major asset classes over the last 13 years. A correlation of 1.0 means asset classes move in lock-step, while -1.0 means they move precisely opposite.

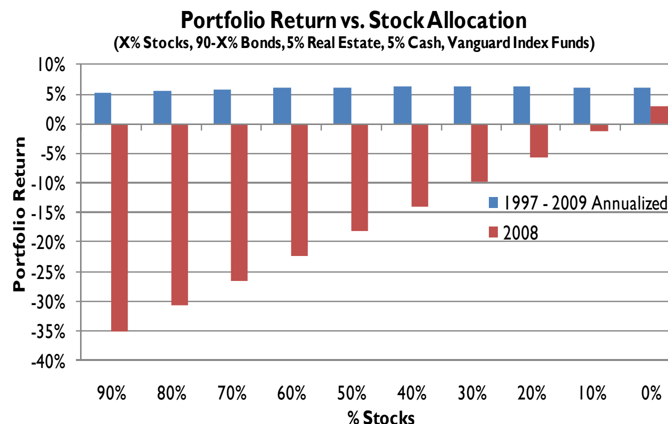
Annual Correlations & Returns - (1997 - 2009)*

	US Stocks	Bonds	Real Estate	Cash	Ann'lzd Return
US Stocks	1.00				4.93%
Bonds	-0.19	1.00			5.96%
Real Estate	0.45	0.02	1.00		7.52%
Cash	0.05	0.32	-0.26	1.00	3.54%

* Vanguard index fund proxies

The correlation between US stock and bond returns from 1997 -2009 was -0.19, implying a slight tendency to move in opposite directions. Thus, adding bonds to a portfolio of stocks significantly reduces the risk of, or diversifies, the portfolio. In poor stock performance years, bonds will help offset stock losses and vice versa.

The blue bars in the graph show how a portfolio with varying allocations to stocks and bonds, and constant 5% allocations to real estate and cash, would have performed over the 13-year period. Surprisingly, there is little variance in the annualized returns as the stock allocation changes. Below-average stock returns for the period studied are largely to blame. However, one should not conclude that asset allocation is largely irrelevant. The red bars show how the portfolio would have performed in 2008, when stocks lost 37%. For an investor needing a significant portion of their money in 2009, the correct asset allocation was critical.



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Our Two

We have long had death and taxes as the two standards of inevitability. But there are those who believe that death is the preferable of the two. "At least," as one man said, "there's one advantage about death; it doesn't get worse every time Congress meets."

Erwin N. Griswold

Quarterly Trivia:

What New York Stock Exchange stock, back in 1989, had no employees?

Wabash Railroad, which had as its principal asset 1700 miles of railroad track, but no trains. It owned the track from Buffalo to Omaha, that it leased out.