The Rennie Quarterly Return

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Asset Allocation – Exposure to "Risky" Assets

When investment pundits opine about investor risk, they immediately focus on asset allocation and the proper split between stocks and bonds, i.e., risky assets and safe assets. They start with the old rule of thumb that age is the determining factor. If you are 25 years old, then 25% of your assets should be in bonds and 75% in stocks. If you're 75, it's exactly the reverse—75% in bonds and 25% in stocks. While this concept has some validity and is intuitively appealing, it falls far short of the proper determination for controlling exposure to risky assets. Obviously, major factors to be considered are the investor's wealth, health, level of expenses and plans for the future just to name a few. For example, a healthy, wealthy, retired 75 year old can afford much more risk than a still-employed counterpart with health problems, a small investment portfolio, and expenses that consume all wage-related and investment income.

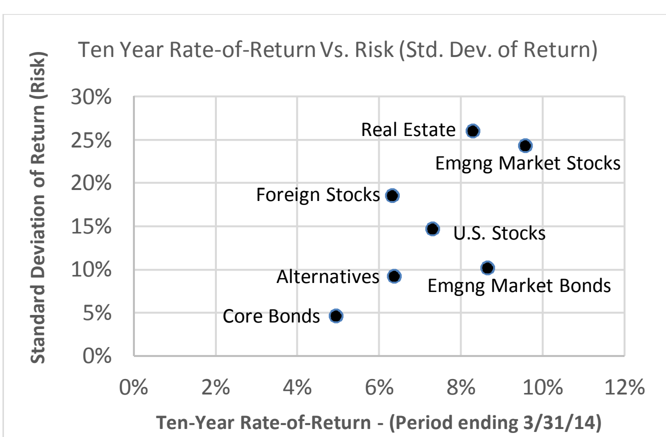
The purpose of this Newsletter, however, is not to expound on asset allocation. It is to describe the process we use to measure exposure to risky assets once the optimum level of investor risk has been determined. For sure, it is not simply the percent of a portfolio invested in stocks. In most portfolios, we generally recommend exposure to seven asset classes: U.S. stocks, foreign stocks, emerging market stocks, core bonds, emerging market bonds, real estate (REITs) and alternatives. A relatively large base of reliable historical data is available for each of these giving some level of confidence in expectations for their future long-term rates-of-return, volatility (risk), and inter-asset class correlations. Consider this sample asset allocation:

- U.S. stocks 40%
- Foreign stocks 5%
- Em Mkt stocks 5%
- Core bonds 35%
- Em Mkt bonds 5%
- Real Estate 5%
- Alternatives 5%

A quick take on exposure to risky assets would be 50%, the sum of U.S., foreign and emerging market stocks. The graph below, however, shows that real estate is the northern-most plot on the risk axis (the Y axis); it must be considered a risky asset.

Bonds are a bit more complex. When referring to bonds as the safe asset class, analysts generally mean highly-rated bonds, i.e., investment grade bonds. However, most of the core bond mutual funds that we recommend hold an average of about 20% of the portfolio in high-yield bonds, those below investment grade. Used judiciously, high-yield bonds offer an opportunity for added value with minimal additional risk. Emerging market bonds add considerable return, but still with an acceptably low level of risk. Alternatives, as we use them, are intended to add some value over core bonds, again with an acceptably low level of risk.

Getting to 55% risky assets is the easy part—the sum of stocks and real estate. To our knowledge, there are no professionally-accepted metrics available to assess the rest. Therefore we use the very straightforward "20%" approach: for high-yield bonds-20% x 20% x 35%=1.4%; for emerging market bonds—20% x 5%=1%; for alternatives—20% x 5%=1%. Thus, the sample asset allocation portfolio now recognizes 58.4% exposure to risky assets which we believe is much more accurate than the naïve 50% assumption.



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Our Two

If you don't know who you are, the stock market is an expensive place to find out.

Adam Smith

Quarterly Trivia:

What are the current names of the following: Persia, Bombay, Volgograd, Burma, Peking

Iran, Mumbai, Stalingrad, Myanmar, Beijing