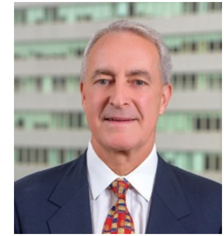
ALEX. BROWN
A DIVISION OF RAYMOND JAMES

THE BORIS-KAPLAN GROUP

Thoughts for Investors



Albert C. Boris, III
Managing Director, Investments

The Hype of Asset Allocation

DECEMBER 2005

"Millions saw the apple fall, but Newton was the one to ask why."

– Bernard Baruch

Bill Gates, the chairman and founder of Microsoft, just got a 3% salary increase after his annual performance review. His salary will go from $600,000 to $620,000. Some readers will marvel at that number, imagining all they could do with $620,000 a year. Others will immediately be struck by the fact that they make more in salary than one of the world's richest men – perhaps substantially more. Yet, even though he makes "only" $620,000 per year, Bill Gates' total net worth is $51 billion. How is this possible? It is certainly difficult to create net worth with a modest income even if one has modest spending habits. And even if one has a high income, it can be difficult to create net worth with lavish spending habits. Yet net worth is created all the time. It is done by understanding the role of two important principles. The first principle is investing versus merely saving. The second is to exhibit proper investor behavior (something I've written about previously). Proper investor behavior is manifested in the process of building an investment portfolio that itself involves three parts: asset allocation, stock selection, and market timing.

"The painter will produce pictures of little merit if he takes the works of others as his standard."

– Leonardo da Vinci

Curiously, many financial planners and consultants have continued to downplay stock selection and market timing by advocating investing in index funds and exchange traded funds (ETFs), while hyping the role of asset allocation. Asset allocation is defined as the distribution of a portfolio's holdings by type of asset (such as large cap value or international small cap growth) and including them in a portfolio. Planners and consultants are fond of using "asset allocation models" when constructing portfolios. Asset allocation models are computer-generated reports that use an asset class's historical return as the basis for its inclusion in a portfolio. In this newsletter I will explain how asset allocation has gotten so popular and why it can be detrimental to the process of creating net worth. Today's preoccupation with asset allocation has its origins almost 20 years ago in a study done by Brinson, Hood, and Beebower and published in the Financial Analysts Journal in July/August 1986. In May/June 1991 they published an update in the same publication. Over the years, the study's conclusions have become convoluted. Today some investors believe the study to show that of the three parts, asset allocation is the major determinant of a portfolio's returns and that stock selection and market timing play insignificant and sometimes negative roles. This is incorrect.

"When all think alike then no one is thinking."

– Walter Lippmann

What the study actually concludes is that asset allocation is the major determinant of the volatility (or variability) of a portfolio's return. Asset allocation itself does not drive the return. In fact, it adds multiple layers of complexity to achieving a return. First you have to correctly define the asset classes. What exactly is a value stock versus a growth stock? Next you have to assume that those who have defined the asset classes have populated them with the correct stocks. Should

Microsoft be in the growth or value category? What about General Electric? Finally, even if you intend to use index funds (which have idiosyncratic natures of their own) you then must predict the performance of that asset class. Guessing which direction, if any, interest rates will go in the coming year is crucial to deciding how much bond exposure is ideal for the portfolio. Morphing the explanation of asset allocation's role from one of determining a majority of the volatility to determining a majority of the return is complicated and misleading.

It is misleading because return is determined by risk not by volatility. Unfortunately, investors believe these are the same terms when in fact they are not. Volatility is a collection of many human actions – the stock market. Risk is a product of a single human action – that of the individual investor. For example, a stock that fluctuates between $20/share and $100/share in the market in a given time period is indeed highly volatile. Yet any investor buying it at $20/share and looking at it priced on their statement at $100/share is unlikely to call it risky. By the same token, if several months later the price of the same stock dropped from $100/share to $50/share, many of those same investors would start considering it risky (although they still enjoy a 150% gain!). Other investors unfortunate enough to buy at $100/share would indeed call it risky when it drops to $50/share. How can the same stock be highly volatile and also risky and not risky? And so how can volatility be said to be equal to risk? Volatility is a component of risk. Volatility can be reduced through the diversifying effect of asset allocation. Yet lowering volatility may not lower risk. If one component of risk is vanquished, then another, such as inflation, can rise to adversely affect return. For example, bond portfolios run the risk of not outpacing inflation. If inflation is 4% and your bond yields 4%, then your inflation adjusted real return is 0% and you risk not having enough money to meet your goals (although you do have a portfolio with lower volatility than someone with a stock portfolio). When a portfolio is composed of 100% bonds, it is helpful to have a great deal of money because you will not be creating any new net worth.

In the end you cannot spend either low risk or low volatility. You can only spend return. Eventually, asset allocation models often fail on a return basis. While the models are busy managing the volatility created by the stock market, investors are not getting the returns they assumed the models would yield. Investors then make the further mistake of thinking that their current asset allocation is incorrect, which compels them to re-jigger the portfolio to suit a new asset allocation model (more business for the consultant, more cost to the investor).

"Diversification is only a poor surrogate for knowledge, control, and price consciousness."

– Marty Whitman, Founder, Third Avenue Mgmt.

Another negative side effect of the preoccupation with asset allocation is over-diversification. This can also adversely affect return by watering down the positive effect of any single good investment. This is where concentration (in moderation) becomes important. Noted investor Benjamin Graham advocated for no more than 35 or so stocks in a portfolio to achieve proper diversification. Warren Buffett explained that over-diversification was a way for an investor to cover up his ignorance. If concentration helps guard against over-diversification, then the specific investments you choose (i.e., stock selection) become important in determining a portfolio's return. Again, this is contrary to the common interpretation (we could say "misinterpretation") of the Brinson study. In summary, there is no easy answer to achieving a good return. Asset allocation plays a role in determining return, arguably not the central one, and certainly not enough to use on autopilot. Asset allocations most important role may be to rein in investor behavior with respect to impatience, fear, and greed. Stock selection (and the portfolio manager who picks the stocks) is important, maybe centrally important, in determining return. It is similar to the importance of the stones and the stonemason who builds the house. Furthermore, the selection of a concentrated portfolio (of the right stocks) yields the best potential for great returns and for building great net worth – just ask Bill Gates.

.”

AUDI PARTEM ALTERAM

Hear the Other Side

The Boris-Kaplan Group // 1735 Market Street, Suite 1400 // Philadelphia, PA 19103 // T 215.563.2300
www.alexbrown.com/boriskaplan

If you would like to discuss the topic of this newsletter, or our team’s approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

Thoughts for Investors is a quarterly newsletter written for clients since 1997 by this author. The purpose is two-fold. First, it is meant to help explain the investment philosophy that guides the author’s approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.

To subscribe, unsubscribe or to request back issues mentioned in this newsletter simply send an email to al.boris@alexbrown.com

Raymond James & Associates, Inc., Member New York Stock Exchange/SIPC. Raymond James is not affiliated with any companies mentioned. Opinions expressed in the attached article are those of the author and are not necessarily those of Raymond James. All opinions are as of this date and are subject to change without notice. Keep in mind that there is no assurance that any strategy will ultimately be successful or profitable nor protect against a loss. Investing involves risk and you may incur a profit or loss regardless of strategy selected.