

**Book Review**  
**All About Asset Allocation**  
Richard A Ferri, CFA

Richard Ferri's classic book is an easy read and a wealth of wisdom on how to construct a portfolio. Investors will do well to read it before investing, or to delegate to an advisor to implement the practices in the book.

Intro: "Block out the gurus who say that they can tell the next move in the stock markets, interest rates, or the price of gold, because they don't know. Focus instead on those advisors who recommend developing a long-term investment policy using a diversified asset base, and then implementing that policy with diligence, dedication and discipline."

Diversify across different securities, keep cost low, and control for risk and taxes.

Develop an investment policy statement, which is a statement about how you will implement and maintain your portfolio. Your asset allocation decision is one of the most important decisions you will make in your life and is worthy of significant time and thought. Almost all of your returns and risk will be determined by asset class selection.

Your investment policy statement should include your financial needs, investment goals, asset allocation, description of investment choices, and why you believe this plan should get you to your goals over time.

"A well-designed portfolio lowers overall risk through diversification, and this eventually results in a return that's higher than the weighted average return of the individual investments in the portfolio."

Volatility will make the compounded return lag the arithmetic average return. Reducing volatility without lowering expected return (through diversification) increases return.

Diversification reduces the chance of a large loss, rebalancing helps contain risk, correlations between asset classes are not static, low correlations are preferred, but difficult to identify.

Multi-asset class investing: owning several asset classes is better than owning a few, each new and unique asset class can reduce portfolio risk. Choose asset classes that have positive real returns and lower correlation. There is no perfect asset allocation, but there are good ones. There are no negatively correlated asset classes. Sometimes classes' correlation goes negative, but it doesn't stay that way. Assets classes should fundamentally differ. Look at rolling correlation. Liquid and low-cost funds should be accessible. There is no ideal rebalancing strategy. Pick one you will use consistently.

Every investment in the portfolio should earn a positive real return. If an investment is not expected to make money, it doesn't matter what the correlation is, avoid it.<sup>1</sup>

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<sup>1</sup> Mathematically, I can create a counter-example. A security that has a high average return but occasionally has near wipe-out losses can enhance a portfolio with diligent rebalancing. In the real world, however, avoiding negative returning investments is prudent.

#### Four Step Process:

1. Determine risk level, and convert into equity/fixed income split.
2. Analyze asset classes and choose based on: risk, expected return, past correlation, tax efficiency
3. Pick securities for each asset class chosen. Low cost ETF's work well.
4. Implement plan completely, rebalance periodically.

Value stocks outperform growth stocks by several percentage points over the long-term, and outperformed during most independent 10 year periods. The value premium pertains to foreign stocks as well. Large cap value stocks have had better returns over time than growth stocks, with less volatility. Small cap has an even stronger value premium.

"There is no benefit to holding a growth fund and a value fund in equal amounts. Yet, this strategy is one often recommended by investment advisors. A better strategy is to hold the total market and add elements such as small cap value and value based on the total risk you are seeking.

Over a 30-year period (1979-2009), a mix of 70% total market and 30% small value would have increased US equity returns by 2.0% with very little increase in observed portfolio risk.

International Equity Investments: Int'l equity provides currency diversification, developed markets include advanced countries, emerging markets and frontier markets expand into new geographies, int'l equities exhibit size and style premiums.

"Building your own US and international stock allocation is a better method than using a global fund because there are greater diversification opportunities. In addition, holding different regional funds in a portfolio and rebalancing them annually helps you control the amount of risk exposure to any particular region and currency." Generally international allocation is around 30% of the equity portion.

Fixed Income: there are several FI categories, with unique risks and return characteristics.

Diversification across FI classes enhances return. Low-cost bond funds are an ideal way to invest.

Credit risk is risk of downgrade. Default risk is risk of non-payment.

The correlation between credit risk premium and equity risk premium is dynamic and sometimes changes rapidly.

Real estate investments: RE is a separate asset class. Real Estate Investment Trusts (REITs) are a convenient way to invest in real estate. They have low correlation with stocks and bonds at times.

Home ownership provides a place to live and potential gains, but should not be considered as part of the investment portfolio (too difficult to rebalance) but rather as a reduction of expenses when calculating funding needs.

Alternative Investments: alternative asset classes bring more opportunities for diversification, but many are difficult to invest in, and illiquidity and high costs can negate any advantage.

Hedge funds are investment tools, not an asset class. There are a lot of problems with hedge funds, especially high fees. Performance is not persistent. Often historical returns are deceptive due to survivorship bias, selection bias and inconsistencies in pricing.

Collectibles can be fun, and their long-term performance rivals that of stocks, but investing in collectibles takes skill, and transaction costs are high.

Realistic market expectations are important to investment planning. Volatility is more predictable than returns. There is a long-term relationship between market risk and expected return. Market forecasts are useful in the long-term, but not in the short-term.

Two models for estimating long-term returns: risk-adjusted returns and economic factor forecasting.

Risk-adjusted returns model relies on historic market volatility to forecast relative future performance.

This model builds up risk premiums. It starts with inflation, adds a risk-free-rate (T-bills) and then adds credit risk premium, then equity risk premium, then small cap premium.

Economic Factor Forecasting model: Equity Return = EPS growth + cash dividends + valuation change.

Fixed-income return = yield at purchase + change in yield. Change in yield = change in inflation rate, the real RFR and credit spreads.

Building your portfolio: A proper allocation should match the investor's needs, with overall risk not above one's tolerance. The life-cycle method is a good starting point, and "your age in bonds" is also helpful for young people, but is too generic for people nearing retirement.

How behavior affects asset allocation decision: staying below your max risk tolerance is imperative to prevent emotional mistakes. Asset allocation stress testing helps refine investor tolerance. Rebalancing helps stay in line with your investment policy.

Observations by behavioral investment researchers:

- People are more optimistic about the market after it goes up and more pessimistic after it goes down.
- Investors overweight recent data.
- People favor investments that just had a big run. Over 80% of mutual fund new assets go to funds with the best one-year record.
- Investors label investments as "good" or "bad" based on what they paid vs. today rather than current fundamentals.
- People are reluctant to admit error, so they pay high fees to others so they have someone to blame.
- Investor confidence in the earnings of high-priced companies is too high and vice versa.
- Overconfident investors believe they have more information and skill than they really do, resulting in over-trading and underperformance.

Vanguard found that the poorest performing 401k's are held by the most educated people and the most confident investors.

Psychologists have found that the pain of loss is 2x the thrill of gain.

Risk tolerance questionnaires are a good start, but not perfectly accurate.

Actual risk tolerance is generally lower than declared risk tolerance.

“If you assume too much risk in a portfolio, there is a high probability that you will abandon your investment strategy during severe market downturns.”

Once you’ve reached your financial goals, or are in a good position to do so, there is no reason to remain at peak risk tolerance.

3 Reasons to change allocation:

1. Your financial goal is well within reach.
2. You realize that you will not need all your money during your lifetime.
3. You realize that your risk tolerance is not as high as you thought.

Benefits of an investment manager:

1. Planning and implementation
2. Consistency of strategy
3. Create a circuit breaker
4. Place someone on duty 365 days per year.