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Where Are We Now? Where Do We Go From Here?

The weather is warming up, the Royals are tied for first place and the first quarter of 2016 is in the books. With everything going so "right", let's look forward to where we are heading. In investing jargon, that means discussing asset allocation.

Any security that we invest in can be considered an asset. We organize similar assets into classes and examine the differences among these asset classes to determine the risk and reward characteristics of each – which then enable us to construct a portfolio that best suits the needs of the client. That's simply a boring way of saying, “don’t put all of your eggs into one basket".

The study of asset allocation has been the subject of countless books and research papers winning numerous awards. However, the concept of asset allocation is often misunderstood, or misrepresented. We will try to make this discussion pertinent, meaningful, and understandable; but we will probably not win any awards.

First, back to asset classes. The three major asset classes are stocks, bonds and cash. These are the three that we reference 99% of the time, and will be the ones we focus on. Are there other asset classes? Of course there are, and more are being created every day. Real estate and commodities are the two that spring to mind, but there are also sub-classes of each asset class.

Stocks are divided into domestic and international stocks. International stocks are then divided into developed markets, developing markets, and emerging markets; and let us not forget to mention, large capitalization, mid-capitalization, small capitalization, and micro-capitalization stocks. To further complicate matters, there are no standardized measures as to what delineates the categories. Are large cap stocks over $4 billion, or over $10 billion, or over $25 billion? Are micro cap stocks those under $1 billion, or $100 million, or $10 million?

Bonds are often grouped by length of maturity (how long is long, how short is short?), credit rating, taxability, country of origin, and so on. Again, each of these groups can be broken down into smaller and smaller groups, none of which have standardized definitions.

It is obvious that when definitions are not standardized, results from using different definitions will not be consistent. That is why so many studies are created and reported on, and yet they sometimes have contradictory results. Therefore, we want to keep our look at asset allocation straightforward and simple.

Taken to the last degree, assets can be broken down into simply too many categories to be useful. An example was during the mid- 1980's to mid-1990's when there was a special group of people on Wall Street called "strategists’". This period of time was after investors had learned that information was the gold they were seeking, and whoever got to it first was at an advantage. This period was also before the internet gave EVERYONE the information at the same time. Strategists knew where the "gold" was, and passed it out as they needed. The strategists are still around at every investment house and brokerage firm, but they are not the wizards they were once thought to be.

Even though that is a very clumsy metaphor, the gist of it is accurate. Did it really benefit any investors to hear from a Wall Street strategist that he was moving "2% away from international emerging market stocks and into developing real estate economies"? It probably did not. However, it did benefit his investment bankers and salesmen who were going to pitch a real estate proposal in a developing nation.

On a more general plane, even moving 5% of a portfolio from stocks to bonds will probably not have an outsized effect on an individual's portfolio over the short run. That is why asset allocation decisions should be made with the long-term in mind, and usually for very broad asset classes.

Let's say that you need $100,000 from your portfolio for a specific purpose in about one year. Understanding that the S&P 500 (stocks) have averaged 9.5% per year since 1928, you could surmise that if you invested your $100,000 in the S&P 500 index that you would have enough money for your purchase PLUS $9,500 to keep at the end of the year. We all know that this argument is specious, and ill-conceived due to volatility.

Perhaps you get lucky, and you make 30% that year or perhaps you get unlucky, and you lose 30% that year. Both are realistic possibilities, but neither has a higher probability of occurring. So, what is the course of action? In this situation, the $100,000 earmarked for next year should be invested in a cash vehicle with a 0% probability of loss.

So, what's the point of investing if we're going to be so safe? Good question. The answer is to put risk/volatility in your portfolio, by implementing the appropriate asset allocation. We will not need all of our money within one year, so we do not invest it all in a riskless manner. However, we do need to understand that volatility happens and we need to understand that volatility is a good thing. For without risk, there is no reward.

We are discussing asset allocation with this newsletter because within the last year, we have seen volatility in the stock market from month to month. In August 2015, the S&P had a negative 6.0% return, but during October 2015, the S&P had a positive return of 8.4%. The first part of 2016 has been volatile too; with the S&P returning a negative 4.9% in January, and a positive 6.7% in March. Each and every time there is a month where the results are vastly different from the previous month, there are questions as to whether or not one should bail out or jump in to the market. The answer now, as always, is neither.

Think of investing like taking a trip. Let’s assume there are only three modes of transportation: walking, driving or flying (cash/bonds/stocks). If you are simply walking to the next neighborhood, you have plenty of time and the weather is nice, so you simply walk. You get to enjoy the trip and not worry about traffic, filling up with gas, potential accidents or what not. You get to your destination on time.

However, there are places you need to go that you cannot walk to and you must drive or catch a flight. Are there benefits to those? Absolutely, but these also have risks. If you're driving, you have more control over the situation then if you are flying. You might hit a traffic light or two, get stuck behind a slow moving vehicle, or even have a flat tire. That's volatility for bonds; identifiable, and manageable. However, with good planning and no disasters, you will get to your destination on time, whether it is across town, or across the country. Driving is predictable and safe, and you can cover much more ground than you can by walking.

Now, let's say you want to cross the country faster or you want to go to London. You choose to fly, but you have to first get to the airport and wait for the scheduled departure. You have to go through security, and you have to wait for your plane to get to the gate. These are all issues (volatility) out of your control. Perhaps there is a weather issue and you are re-routed around the storm or worse yet, you have to wait overnight for another flight. Maybe you have to fly from KC to Denver BEFORE you even head to London. These volatilities happen every day, and yet we don't cancel our trip because we have a connecting flight, or have a delay. These are some of the risks associated with flight.

Such is the case with some investing plans. I'd like to walk, I'll think about driving, but I absolutely DO NOT want to fly; which will never get you to London. You will have to fly, and risk the volatility of inconvenience and changes in order to get to your destination.

This is an incredibly simple analogy (with plenty of holes in it, I am sure), but you get the idea. If you have a well-planned, realistic itinerary you will eventually reach your destination. You will not be tempted to change plans in the middle of a trip unless an emergency arises (traffic jams, delayed flights, etc. are not emergencies; they are everyday occurrences).

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Craig, Howard, Elizabeth, Ward & Brian

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