

Asset Allocation: Just a Buzz Word?

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Is asset allocation just a “buzzword?” Some physician-investors probably think so. According to a 2006 poll by AllianceBernstein, 25% of the investors surveyed said just that. Over 40% said they don’t use asset allocation at all, whereas 80% of financial advisors thought it was important.

The poll studied both financial advisor and investor responders. The 500 advisors had more than five years of experience and were responsible for \$25 million+ in assets. The 1,000 investors had at least \$75,000 in investable assets.

The poll’s results were shocking because asset allocation is responsible for 92% of the returns in an investor’s portfolio. Those individuals, who think asset allocation is just a buzz word rather than a practical model, are likely losing return because they don’t believe in this scientifically-proven method.

This is why. Asset allocation gleans the most bang for the buck out of a mix of non-correlated asset groups. Non-correlated means that when one asset goes down the others are little affected or go up so that the whole portfolio remains stable. In this way, there is little shortfall in the portfolio during downturns in one asset or another and total losses are minimized. This means that recovery of capital occurs more readily because less recapture of loss is needed.

Example: If a \$10,000 investment drops \$3,000 in value, you lose 30% of your investment. In order to get back to sum 0 (\$10,000), your portfolio has to gain not 30% but 42% (ie, \$3,000 divided by \$7,000). Losing money puts you behind the eight ball.

This asset allocation model is based on modern portfolio theory for which economist Harry Markowitz won the 1990 Nobel peace prize. His theory demonstrated how risk is reduced through diversification of investments that have different patterns of return. For example, domestic and international stocks plus bonds do not go up and down in price together. Instead, when domestic stocks are up, domestic bonds and foreign stocks tend to move in the reverse direction. This is why the most straightforward asset allocation model is composed of the domestic stock market, the international stock market, and bonds. As a group, the movement of each in the portfolio buffers the other.

This is how you can make this model work for you:

- Easy—Use a category of mutual funds called life strategy funds that maintain an asset allocation for you. All you have to do is pick out the risk/return ratio model that suits you.
- Almost Easy—Choose the mix yourself. You have more control and all you have to do is pick out your asset allocation and broad indexes to fit into it. The steps below help with either approach.

Action Steps:

1) Determine the asset allocation model best for you. This is dependent on your age and risk tolerance (defined as an investor's ability to handle downturns in the market).

Generally, the younger you are, the more risk you can tolerate. Usually, if you are a worrier, the less risk you can tolerate.

For example, a 30-year-old with a steady job, who is a weekend sky diver, is likely to choose an asset allocation with more stocks (riskier than bonds) than a 60-year-old retired school teacher who has never been out of Cincinnati where she was born.

A) Easy—For ready-made asset allocation options in a Life Strategy Fund click [here](#) and search for Life Cycle Funds. The first four funds under that category are Life Strategy funds meaning they maintain an asset allocation for you. Click on fund holdings for each category to determine the mix of stocks, bonds, and short-term reserves. The growth fund that is most conservative contains the most bonds and reserves (ie, the Life Strategy Conservative Growth). The least conservative is the Life Strategy Growth. The Income Fund is just what it says, primarily for income and less for growth of capital. Fidelity and T. Rowe Price also have low cost options as well as Vanguard.

B) Almost Easy—Select broad based index funds or exchange-traded funds that fit into an asset allocation distribution of your choice. Examples of broad based funds are: Domestic stock: Vanguard Total Stock Market Index Fund Investor Shares (VTSMX), International stock: Vanguard Total International Stock Index Fund (VGTSX), and Domestic bonds: Vanguard Intermediate-Term Investment-Grade Fund Investor Shares (VFICX). Similar low cost funds can be found at Fidelity or T. Rowe Price.

2) Once put together, figure on a long-time horizon, as patterns are cyclical and the advantage of asset allocation is that it weathers the effect of time well. In other words, at the end of 20 years, it is still standing and almost every portfolio composed of only one asset class is crumbling.

3) Rebalance the model roughly every year. This gives your portfolio an opportunity to benefit maximally from the ups and downs of the market because when one asset is up, another is down. When you rebalance, you are selling high (the asset that increased in price per share and therefore is over represented in the portfolio) and buying low (the asset that is underrepresented in the portfolio because its share price is low).

Warren Buffett said “there seems to be some perverse human characteristic that likes to make easy things difficult.” This is certainly true for investing, which is exploding with fancy bells and whistles when most physician-investors only need a basic instrument—like asset allocation.

A Real Life Story

Dr. Brag A. Lott is in his mid-30s, has dark hair, and is lean as a rail. He's a doctor clearly trying to get ahead because he offers Saturday hours and makes special

concessions to patients. He has a wife who does not work and the couple has two young children.

One of his favorite pastimes during my visits is to tell me how well he is doing in the stock market. He invests with two “hot shots” in the city who buy and sell small company stocks. I once asked the doctor, “Do they practice asset allocation for you or do you do it yourself?” His reply, “What’s that?”

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