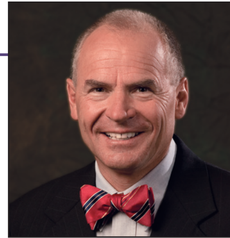
ABOUT THIS SERIES: This newsletter is one in a series about macroeconomic topics that may affect investors in the coming decade. Fritz Meyer is a senior investment officer with A I M Advisors, Inc.

Meyer Report on Asset Allocation

Fritz Meyer



Market volatility is an age-old problem that plagues investors. One of the best methods for coping with volatility is a strategy that was introduced more than 50 years ago—asset allocation. But not all asset allocation strategies are created equal. It's important for investors to know the difference.

How does asset allocation work?

Asset allocation seeks to balance risk and return in your portfolio by investing specific amounts in asset classes such as stocks, bonds and cash, depending on your risk tolerance and financial goals. (Please see the sidebar on page 2 for more about asset classes.)

Why is this important? Because various asset classes respond differently to changing market conditions. For instance, when stocks decline, bonds may rally.

The degree to which asset classes move together is called correlation. Ideally, portfolio components should have a low correlation—in other words, they should not move together in response to market conditions.

When this method of portfolio creation was first introduced in 1952, it was revolutionary for its time. In the early 1900s, investors focused on the risk/reward characteristics of individual stocks, and populated their portfolios with names that looked attractive at the time, without regard to correlation. For example, a portfolio at that time could have consisted largely of railroad stocks—each may have looked good at a certain point in time, but all suffered when the interstate highway system and the airline industry became the leading modes of travel. The stocks' high correlation caused them to rise and fall together.

But in 1952, in a paper that appeared in the *Journal of Finance*, Harry Markowitz introduced the idea that investors should build a portfolio based on its overall risk-reward characteristics, rather than on the characteristics of its individual securities. Today, that concept is known as Modern Portfolio Theory, and it earned Markowitz a Nobel Prize in 1990.

Investing on the curve

At this point, you may be wondering, "Exactly how much of my portfolio should be invested in each asset class?" There's a tool that can help answer that question; it's called the efficient frontier.

As part of his ground-breaking work, Markowitz illustrated how much risk a given portfolio would incur versus its expected return. The resulting graph, known as the efficient frontier, allows financial advisors to use an investor's risk tolerance and financial goals to determine how each investor's portfolio should be

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Asset Classes

Asset classes are the investment categories that represent the building blocks of an asset allocation strategy—each of which offers its own unique risk and return characteristics. While asset classes can be broken down different ways, they typically comprise major categories such as stocks, bonds and cash.

These categories can be further broken down by characteristics like geography (domestic or international), size (small-, mid- or large-cap), investment style (value, blend or growth) or quality (investment grade, noninvestment grade).

Diversification encompasses not only investing in different asset classes, but investing in different funds within each asset class. To achieve this level of diversification, investors can choose several funds for their portfolio on an individual basis, or choose a single asset allocation fund. Asset allocation funds are constructed from a portfolio of underlying mutual funds, but those funds and their target weightings are chosen by a professional money manager, rather than the investor himself. The money manager may rebalance asset allocation funds periodically to make sure they remain on track with an investor's goals. Asset allocation funds are available for a variety of risk tolerances, from aggressive to conservative.

Domestic Equity

Domestic equity funds invest in U.S. company stocks. They offer greater potential for return than bond funds—as well as increased risk—and are best suited for mid- to long-term investors who have an investment horizon of five years or more.

Equity funds are typically categorized by investment style and market capitalization range, and can include such variables as dividend-paying stocks.

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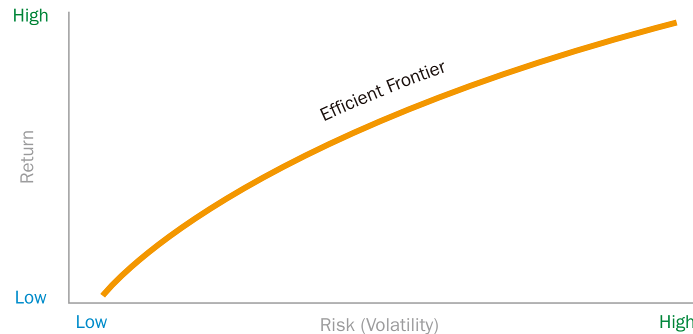
constructed. Using this curve, a financial advisor can construct an "efficient" portfolio—one that offers the maximum return for an investor's preferred level of risk.

The chart below illustrates the efficient frontier. A portfolio placed anywhere on the curve would be considered "efficient" because:

- Each offers a fair trade-off between risk and return
- Each has been appropriately calibrated to an investor's risk tolerance, return requirements, investment goals and time horizon.



Staying on the curve

As markets move up and down, you may find over time that your portfolio allocations have shifted, and your portfolio has fallen off the curve. For example, if bonds have outperformed over a length of time, a portfolio that was originally created with 80% of its value in stocks and 20% in bonds may have shifted to 70% stocks and 30% bonds.

Or you may find over time that your financial picture or investment goals have changed, requiring a new allocation strategy.

When this happens, your portfolio needs to be rebalanced. This should be done periodically to re-establish your original allocations or adjust your portfolio based on new goals and keep your investment strategy on track.

Optimizing your portfolio

A great way to achieve a properly allocated—or "optimized"—portfolio is to invest in one of the many asset allocation funds that are on the market today. Asset allocation funds are constructed from a portfolio of underlying mutual funds, but those funds and their target weightings are chosen by a professional money manager, rather than the investor himself. In many cases, the money manager rebalances asset allocation funds periodically to make sure they remain on track with an investor's goals.

Asset allocation funds can be a great way to optimize your portfolio with a single investment. But, as I said earlier, not all asset allocation funds are created equal. Each money manager adds its own twist to the concept. Knowing the differences is important, and your financial advisor can help you to determine which method is right for you.

How the professionals approach asset allocation

In order to illustrate the methodology and thought-process that goes into portfolio construction, I talked with Gary Wendler, director of product marketing and research at AIM Investments®. Wendler was instrumental in creating the portfolios that underlie AIM's line of asset allocation funds.

Wendler outlined three steps that AIM took in creating its lineup of asset allocation funds.

Step 1: Develop a risk/return structure

First, AIM developed a group of 20 asset classes that could be included in each portfolio—such as large-cap growth stocks and tax-free fixed income investments. The key, Wendler says, was to find asset classes with low correlation.

When developing this asset-class lineup, Wendler and his colleagues employed a statistical technique known as optimization that requires forecasted returns, standard deviation and correlations of the asset classes over a desired investment horizon, and then combined this information with their own analysis.

What type of analysis? The team members studied how each asset class has performed throughout history, examined where we are now in the current market cycle and applied qualitative reasoning to overlay asset class constraints. This is where the expertise of an experienced money manager comes into play, potentially adding value to the process.

Step 2: Build your portfolios.

With the asset-class lineup set, it was time to build the portfolios. Wendler and his team had to make some important decisions about strategy.

- *Target Risk vs. Target Maturity*

Asset allocation funds that take a target risk approach are often labeled as "aggressive," "moderate" or "conservative," and are rebalanced periodically to maintain their designated risk level over time.

Target maturity funds are pegged to a specific date in the future—generally the year that the investor expects to retire. These funds begin aggressively, and their allocations become more conservative as the target date draws near.

Wendler's team chose the target risk approach, because these types of funds give investors—and their financial advisors—more control over their investment strategy, he says. With the help of profiling tools available through their financial advisor, investors can determine their own risk tolerance and judge for themselves how their personal situations are changing over time. They can choose when (or if) to transfer their money to another asset allocation fund with a different risk level.

Target maturity funds run on auto-pilot: All investors are placed on the same trajectory from aggressive to conservative, no matter how their personal situations may change.

- *Strategic vs. Tactical*

A strategic fund will generally have the same asset allocation year after year. For example, if a moderate portfolio is initially designed to be 60% stock and 40% bonds, that will typically not change.

Tactical portfolios try to take advantage of market opportunities, and therefore may switch frequently between products and asset classes.

Wendler's team chose the strategic approach, basing its portfolios on long-term projections rather than short-term bets. "When you're tactical, you're making calls on the market," Wendler says. "That provides an additional opportunity to underperform. We've seen little evidence that anyone has the capability to call the market consistently in a meaningful way."

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Fixed-Income

Fixed-income investments provide income by investing in bonds of various issuers such as the U.S. government, corporations and municipalities. The return on these securities is typically not as high as more aggressive-style investments, but the stability and diversification they provide a portfolio is essential.

Fixed-income investments are typically characterized by their maturity (short-, intermediate- or long-term), tax status (whether the interest they generate is taxable or tax exempt) and credit quality.

Credit quality is represented by ratings that measure the likelihood that the issuer will pay back its debt. However, not all issues are rated. There are many reasons why an issue might be nonrated—such as the fees associated with obtaining a rating, the small size of the issuing entity or the lack of a long track record for new entities. It's important to note that rising interest rates will affect the performance of a fund's fixed-income investments.

Sectors

Sector funds are designed to take advantage of the growth potential in a particular industry or sector of the economy. Some categories include communications, financials, health care, natural resources, precious metals, real estate, technology and utilities. Some funds offer a more concentrated exposure by investing in subsectors of the broader categories, such as wireless service providers (communications) or genomics (health care).

Be aware that investing in a single-sector mutual fund or in a fund with a higher concentration of sectors involves greater risk than investing in a more diversified fund.

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International/Global
International/global equity funds provide an opportunity to invest in stocks in countries around the world. These funds are typically categorized by geography (international funds invest solely outside the United States, while global funds invest in U.S. and foreign markets), investment style, market capitalization and market development (emerging or developed).

Foreign securities have additional risks, including exchange rate changes, political and economic upheaval, the relative lack of information about these companies, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards.

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With these decisions made, AIM then set out to assign the underlying mutual funds to each asset class and create the portfolios. The team tried to minimize overlap (when different funds invest largely in the same stocks), minimize emphasis on any single management team (when the same team manages various funds), and use products that have the best risk/return characteristics within each asset class.

Step 3: Monitor the portfolios

AIM rebalances its asset allocation products annually. An investment oversight committee reviews performance, allocation percentages, expenses, portfolio structure, rebalancing and underlying fund changes.

Although underlying funds could be changed due to events such as a manager change, this happens only rarely, Wendler says. Each fund is in the asset allocation portfolio for a reason. "Our goal is for the aggregate portfolio to consistently outperform its benchmark—not necessarily to have each underlying fund consistently outperform its benchmark," he says. "Some funds are included in the portfolio for downside protection, and may underperform in an up market."

This is the purpose of choosing underlying funds with low correlation—they may not all rise together, but they shouldn't all fall together, either. That was the idea behind Markowitz's Modern Portfolio Theory.

Talk with your financial advisor

"Don't put all your eggs in one basket" is especially true when you're dealing with your nest egg. A properly constructed portfolio will allow you to spread your investments over several different baskets of assets.

Talk to your financial advisor about how to develop a portfolio that's right for you.

Investors should note that investments in asset allocation funds will indirectly bear the expenses of the underlying funds in which the fund invests in addition to the fund's own expenses.

Fritz Meyer is a senior investment officer with A I M Advisors, Inc. He regularly provides both economic and general market commentary for internal audiences and external broadcast and print media. He began his investment career in 1976. Mr. Meyer earned his master's degree in business from the Amos Tuck School at Dartmouth College. He earned his bachelor's degree from Dartmouth College with a distinction in economics.

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Not FDIC insured | May lose value | No bank guarantee

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