

Portfolio Management: The Broad Asset Mixes

Table 1 summarizes the recommended mix of stocks, bonds, and cash from four well-known advisory sources. The suggested asset mixes include stocks, bonds, and cash; they do not include real assets such as one's home or other real estate. While one source explicitly assumes that investors own their home, it is most likely that the other sources implicitly make this assumption as well, and thus assume investors have a real estate exposure.

	Stocks (%)	Bonds (%)	Cash (%)
High-risk investors; young investors	70 - 80	15 - 25	0 - 5
Medium risk investors; investors approaching retirement	60	30 - 40	0 - 10
Low-risk investors; retiring investors and retirees	40 - 50	40 - 50	5 - 20
Investors over age 70	20 - 30	60	10 - 20

Sources: The Vanguard Retirement Investing Guide (Irwin Press); T. Rowe Price Retirement Planning Kit; "The Wall Street Journal Guide to Planning Your Financial Future" (Lightbulb Press), by Kenneth M. Morris, Alan M. Siegel and Virginia B. Morris; "A Random Walk Down Wall Street" (Norton Press, 6th edition) by Burton G. Malkiel

While the recommendations vary, they are more similar than dissimilar, and reflect key portfolio management investment truths. Some of these truths are self-evident, but they are so basic to investing that they are worth explicitly restating. Others are not self-evident, but they are important elements of a sound and balanced portfolio. Here is a run-down of the "investment truths" derived from the recommendations' common elements:

- A fixed-weight strategy, with rebalancing at least annually, is an excellent strategy and should be considered the cornerstone of effective portfolio management.

Each of the sources recommends specific asset mixes at different points in an investor's life cycle. In order to maintain a given asset mix, the portfolio must be periodically managed and rebalanced. The simple idea is that a stable asset mix gives an investor a stable risk exposure that is appropriate for his or her financial needs, which are typically dictated by their stage in life.

A fixed-weight strategy is a long-run contrarian strategy. When stocks rise from being fairly valued to overvalued, the investor sells the overvalued stocks and buys bonds (or cash), or when putting new money into the portfolio purchases bonds or cash rather than stocks. When stocks fall from being fairly valued to undervalued, the investor sells bonds and buys the undervalued stocks, or uses new money to buy stocks. In short, a fixed-weight portfolio management strategy allows someone to profit from market misvaluations while maintaining a stable risk exposure.

- Effective portfolio management practices avoid market timing.

Market timing calls for sharp swings in the stock/bond/cash mix based on expected near-term market prospects. For example, a market timing service may recommend shifting the stock allocation from 80% one month to 10% the second and to 60% the third. By definition, market timing advocates an unstable risk exposure. All sources are unanimous in their discouragement of market timing as part of an effective portfolio management program.

- A portfolio's risk can be moderated by mixing stocks and debt.

Stocks are claims against real assets. Bonds and cash are debt, usually promising fixed returns. Stock and debt are fundamentally different animals and, consequently, their returns tend not to follow similar patterns to each other. Consequently, combining stocks and debt moderates the portfolio's risk.

On a broader scale, individuals who hold stocks and debt in their investment portfolio and own their own home have their broad portfolio diversified among stocks, debt, and real estate—three asset types whose returns do not vary closely together.

- A portfolio management truism to use as a guide state that the longer the investment horizon, the larger the portion of the portfolio that should be allocated to stocks.

Young investors who are years from retirement can invest more of their portfolio in stocks than the elderly. Although year-to-year stock returns are volatile, the young can be reasonably confident that the good years will more than offset the bad years over their investment horizon. As you age and your investment horizon shortens, you are less confident that there will be enough good years to offset the bad, and the recommended allocation to stocks decreases.

- As part of their portfolio management plan, everyone should have some exposure to stocks, even a conservative 80-year-old couple.

Historically, the returns on a portfolio of long-term Treasury bonds have been more volatile (that is, riskier) than a portfolio with 90% bonds and 10% common stocks. Stocks held alone are riskier than bonds held alone, but due to the magic of diversification you can add some stock to an all-bond portfolio and actually reduce the portfolio's risk.

Diversification means not putting all your eggs in one basket even if the basket looks safe. Since 1926, the volatility of an 80% bond/20% stock portfolio has been equal to that of a 100% bond portfolio. This helps explain why no one recommends a stock weighting of less than 20%.

Examination of the detailed recommendations of the sources reveals other widely-held portfolio management investment truths:

- Diversify within the stock portion of the portfolio. In particular, an investor should always have an exposure to large-value and large-growth stocks.

There are two dimensions to investing in the stock market: size and style. Size refers to the size of the firm. In general, the 500 stocks comprising the S&P 500 are considered "large" stocks, which account for almost 75% of the market value of all U.S. stocks.

Style refers to the investment style or philosophy to which a company is most likely to appeal. Growth investors seek growth stocks—firms with fast-growing earnings. They tend to have low dividend yields, high price-earnings ratios, and high price-to-book-value ratios. Value investors seek value stocks—firms whose shares are selling below their "real" value. They tend to have high dividend yields, low price-earnings ratios, and low price-to-book ratios.

Diversification within a well managed stock portfolio would consist of investing some portion in each of these areas—large- and small-capitalization stocks (with proportions roughly equal to their weighting in the total stock market, a 75%/25% large-cap/small-cap mix), and growth and value stocks.

- International stocks should be a part of everyone's portfolio, with the possible exception of the elderly.

Portfolio management Recommendations for international exposure start at about 15% to 20% for younger investors, and gradually decrease as one gets older. One source recommends no exposure for those who are 75 or older.

- Young investors should put more emphasis on international stocks, small stocks, and growth stocks while older investors should put more emphasis on large-cap stocks, especially value stocks.

While broad diversification is always encouraged, younger investors can take more risk, and can therefore place greater emphasis on the riskier portions of the stock market; older investors can still invest in these areas, but their portfolio management emphasis should be on more stable, large-capitalization companies.

- Investors can avoid the emerging international stock markets.

Emerging stock markets promise a wild and bumpy ride. Dramatic gains are possible, but so are equally dramatic losses. Only one source mentions emerging markets, and that source does not advocate an exposure to emerging markets for investors who are in their late 30s or older. The consensus view is that an investor can safely avoid these stocks.

- As one ages, shift the bond portion of the portfolio from primarily long-term bonds to primarily intermediate-term or short-term bonds.

Bond prices become more stable as maturity shortens. Thus the advice to shorten bond maturity as one ages is consistent with the other advice to move toward assets with more stable prices.

- As one ages, the cash portion of the portfolio increases.

Increasing cash assets is part of shortening the bond maturity for increased price stability.

- High-grade corporate bonds and Treasury bonds of similar maturity are close substitutes.

No one distinguishes between buying high-grade corporate bonds or Treasury bonds of similar maturity, because the returns on these bonds move very closely together, although high-grade corporate bonds tend to have slightly higher yields. In contrast, high-yield bonds have a much higher default risk and consequently are lower-graded; these are not close substitutes for high-grade corporate or Treasury bonds.