



BY KENNETH L. FISHER

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The Trouble with Asset Allocation

A rigid allocation has a narcotic effect. It makes you feel good, but it's dangerous to your financial health.

MOST INVESTORS pay scant attention to what is actually the single most important investment decision they make — asset allocation. It's not their fault. The media and our investment industry promote poor advice on this topic. Folks are urged to place money in rigid percentages of cash, bonds and stocks. This suggestion, accepted by many at face value, has little theory underlying it and is basically wrong.

Almost every perception held by investors regarding asset allocation and style allocation is flawed. Way back to the founding of modern portfolio theory, what has been important is not stock-picking or fund-picking but how your entire portfolio performs. You may be euphoric over stock picks that beat the market; but if two-thirds of your

portfolio is in bonds and cash, another investor who had a greater weighting in average-performing stocks likely did better. It's not how some of your money does that counts; it's how your entire portfolio performs and how the pieces fit together to create that result.

Who did well in recent years and who didn't had much to do with bonds. The more you held, the worse you did. The media focused on the stock market's wiggles. But what really was 1999's big loser? Bonds!

Few in the media chronicled the 30-year Treasury bond's negative 11.6 percent total return — after the coupon — for 1999's first three quarters. You bet they would have noticed if stocks did that. You can also assume this has done some real damage to portfolios.

Many interpret the fixed payment and slightly lower volatility of bonds to mean they are safer than stocks. But during much of this century, bonds were actually riskier. You can measure this several ways statistically: frequency of losses, amount of losses over rolling time periods of varying duration, or retention of purchasing power. Bonds can't afford these drawbacks, because their returns don't justify them. Stocks beat bonds from 1926 through 1998 by an average of 454 percent to 125 percent for all 15-year rolling periods, and 834 percent to 170 percent for all 20-year periods.

Bond risk is always greater than most investors believe. Significant ongoing bond holdings is the most common asset allocation mistake. Some folks also hold too much cash perpetually — always a low performing investment. As many investors approach retirement, with decades still to live, they think they need cash and income from bonds. The biggest risk for most retirees is spending their money faster than it grows. Stocks can be easily liquidated for cash, creating "homemade" dividends while still providing growth (and at lower tax rates).

DEALING WITH TOUGH TIMES

Unfortunately, allocation isn't as simple as just owning stocks. Sometimes stock performance just really stinks.

For many years now, I've advocated being 100 percent in stocks. But on rare occasions, market conditions can dictate drastic asset allocation shifts. How rare and drastic is illustrated by the Great Depression. The Fed responded to

the initial collapse in the market by decreasing the money supply and raising interest rates, causing the economy to implode and government bonds to rise. In this environment of inept government policy, Treasury bonds possessed superior risk and return characteristics over other asset classes. Bonds do well in periods of profitless deflation or disinflation, but such periods are rare.

But conditions that cause stocks to fall are often also bad for bonds. Why buy bonds because you're bearish on stocks only to find out that bonds fall almost as much? You must go back to 1990, and before then 1977, to find calendar years when stocks had negative returns and bonds posted

positive results. Real rare! Bonds seldom have superior risk and return characteristics to stocks. But even then, cash is usually better. Usually when stocks fall, cash beats bonds. The last time my *Forbes* column shifted to a significant cash allocation was in early 1990 in my column titled, "It's Here, Folks,"

in which I recommended a shift to 50 percent cash. A little noticed but heavily inverted yield curve then endowed stocks with such bad characteristics that cash became a great alternative. By year end, I was back to advocating 100 percent stocks.

Shifts out of 100 percent stocks for most investors should be rare and fleeting. Otherwise, over time, most investors are much impoverished. Yes, this is an unconventional recommendation; but that is part of why it is right. Folks feel more comfy with big doses of cash and bonds; but it's simply the wrong thing to do. Folks feel comfy on heroin, too. You get the point. A rigid allocation has a narcotic effect. It makes you feel good, but it's dangerous to your financial health.

BUYING SAFETY ABROAD

Ask investors what is the safest, least volatile portfolio, and most will say, "100 percent cash." Wrong. That is almost guaranteed to lose purchasing power over time. Statistically and historically, the safest portfolio has been about 98 percent cash and 2 percent foreign equities.

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While the foreign stocks are more volatile than cash, the two asset classes regularly move inversely to one another. Foreign equity holdings thus decrease the overall fluctuations of the portfolio. When building a portfolio, the aim should be to acquire securities with strong return characteristics that also lower overall volatility by frequently moving inversely to other positions. Portfolio management is about knowing that you always might be wrong. The key is to have two component strategies in a portfolio such that if your main strategy blows up on you, the alternate strategy materially bails you out.

Since 1996, I've reduced the volatility of my U.S. stock holdings by purchasing a smaller weight of foreign equities that possessed better return characteristics than bonds or cash. How so? This U.S. stock market has been driven since 1996 largely by foreign inflows of money from Japan and Continental Europe into America's very largest stocks. That has been my core strategy. Own the largest U.S. stocks. So, what happens if that blows up on me, and money flows back to Japan and Europe? That is what you own Japanese and Continental European stocks for — strategy, counter strategy. In 1998, my foreign holdings were boring, but better than cash or bonds. In 1999, my foreign holdings bested the rest, led by Japan, which so many folks had previously fled.

Another illustration? Imagine an investor who since 1965 evenly divided his boodle each January between the S&P 500 and EAFE. Annualized return? 13.3 percent. Someone placing all his money in the S&P 500 or EAFE would have realized 12.5 percent and 12.3 percent respectively. Not only did this global asset allocation scheme create better returns, but with less volatility. Sometimes foreign stocks are highly correlated to domestic equities. Other times they're not. The trick is to buy foreign stocks when their recent historic returns are closely correlated and then sell them as the correlation widens.

WHEN TO CASH IN

Likewise, the risk and return characteristics of small and large stocks and corporate and government bonds and cash — they all deviate with time. Usually a properly weighted global stock portfolio offers the best method to minimize risk versus return. As stated above, occasionally equities

are too risky, making cash attractive (especially in retirement accounts that can't utilize derivative securities, like index puts, and that don't suffer tax consequences from selling stock positions).

So, when is the rare time for cash? There are only about a dozen major causes of bear markets: A tax hike, an inverted yield curve, trade barrier imposition, war, currency crisis, inventory overhang, shrinking real money supply, redistribution of property rights, redistribution of wealth, natural disasters — you can reach for a few more. The point is the market is a discounter of all known information and these things actually only cause bear markets if almost no one

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knows that they are happening. Hence, to be a successful bear, you must first see that few others are bearish, so sentiment works your way, and secondly that the above-mentioned driver isn't already priced into the market — because almost no one knows it is happening. That's tough and rare.

But because financial markets are always in flux, traditional schemes of rigid asset allocations with rigid percentages of cash, bonds and stocks are guaranteed laggards.

Our industry has convinced many that an investor needs a money market fund, a bond fund and a stock fund — and an emerging market fund, a government securities fund, a corporate bond fund, a technology fund, a growth and income fund, a utility fund, a REIT fund, a tax-free bond fund, a value fund. It's almost never ending. But good asset allocation isn't about exposing yourself to every type of imaginable security and thereby making an investment company rich. All you need is a good global stock portfolio built on two alternate strategies, a very rare move to cash, and an even rarer move to bonds. The hard part is getting yourself and your clients to do it — instead of something else much worse for you. ■

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