



Dougal Williams Responds: The Failure of Asset Allocation Funds

By Dougal Williams, CFA
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The following is in response to a [letter to the Editor](#) from Jerome Porter which appeared last week. That letter was in response to Dougal Williams' article, [A Crash Course in Investing: Six Lessons from the Market Meltdown](#), which appeared two weeks ago.

Mr. Porter outlines three areas in which he believes my analysis of asset allocation fund performance falters. Two of the shortcomings—for which I provide more in-depth research below—can be summarized as follows:ⁱ

A comparison of fund performance vs. an equivalent index mix over just one year—2008—is too short a period in which to derive meaningful results. Results would have more significance if performance was examined over a longer period, say five or 10 years.

Comparing actual fund performance, reduced by management fees and trading costs, to a mix of indices that have no such costs is unfair. Fund performance should be compared to a similar mix of investable index funds, the returns of which are also reduced by fees and trading costs.

Without question, these are valid points. Let me address them in order.

In keeping with the theme my original article, I chose to examine fund performance over just one year. The heart of the financial crisis was 2008, so I was interested to see whether fund managers succeeded in beating the market through tactical moves in that year as compared to other years. Certainly, conclusions drawn from just one year of data are likely to fail the test of statistical significance. Looking at results over longer periods, while far from a guarantee of future success, carries more weight.

If, as Mr. Porter suggests, we look at the performance of asset allocation funds over trailing 5- and 10-year periods, we find a similar story to what I presented in my article: The majority of asset allocation funds still fail to beat an equivalent index mix.



Tactical Funds Outperformed by Benchmarks



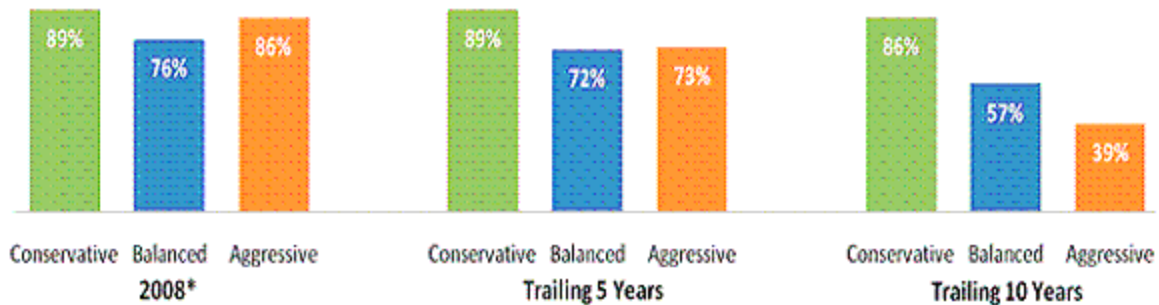
Source: Periods ending 12/31/09; Morningstar Principia

Across all three risk profiles (conservative, balanced, and aggressive) a total of 111 funds have 5 years of trailing performance. Of those 111, 80% failed to match the benchmark return. Of the 76 asset allocation funds with 10 years of performance, 70% failed to keep pace with the benchmark.

As Mr. Porter correctly points out, however, these results use indices, not index funds, as the basis for comparison. The indices have no management fees or trading costs associated with them. Comparing asset allocation fund results to actual investable index fund performance is a fairer comparison.

In his response, Mr. Porter suggests I choose two “long term surrogates” for the indices to better reflect the impact of fees and costs. Rather than be criticized for selecting two index funds “with the benefit of hindsight,” I decided to look at all total stock and bond market index funds with 10 years of performance. By taking an average of all these index funds (readily available to all investors) we can make an apples-to-apples comparison and address the following question: *had you invested in a mix of the average total stock market index fund and the average total bond market index fund, how would you have fared vs. a choice of the average asset allocation fund?* The results are below:

Asset Allocation Funds Outperformed by the Average Index Fund Mix



Source: Periods ending 12/31/08; Morningstar Principia

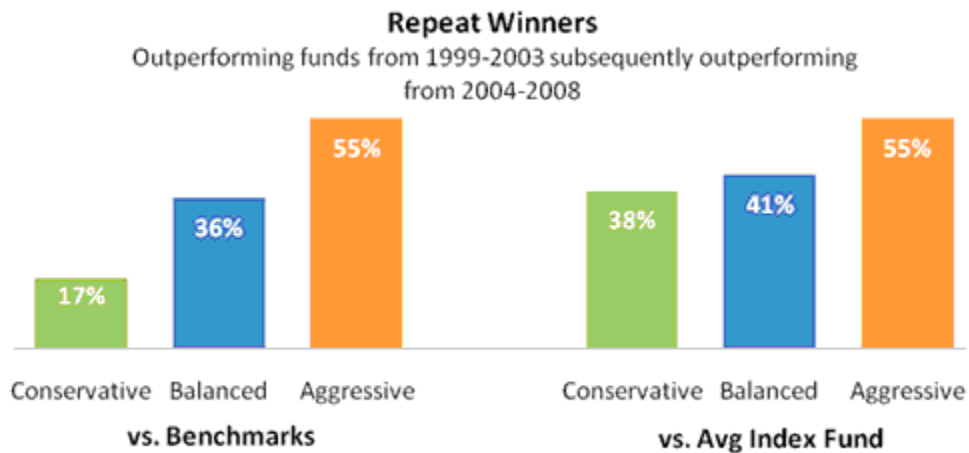
In most cases, as one might suspect, the percentage of asset allocation funds outperformed by the average index fund mix falls relative to the comparison using the indices themselves. Management fees and trading costs—while generally less for index funds than for actively-managed funds—still matter. The results, however, still overwhelmingly favor index funds:

- Of the 111 asset allocation funds with 5 years of performance, only 26 managed to beat an equivalent mix comprised of the average index fund. 85 funds—76% of the total—failed to do so.
- Of the 76 asset allocation funds with 10 years of performance, 30 beat the index fund mix. 65% failed to match the average index fund mix.

Advocates of active management may, of course, flip this data on its head and point to the 20% to 30% of funds that actually beat either the benchmark index or average index fund over 5 and 10 years, respectively. What about those funds? Can they be identified in advance?

Not based on trailing 5-year performance, at least.

If we look for “repeat winners”—those funds beating the benchmark in the first five years (1999-2003) *and* the subsequent five years (2004-2008)—we might conclude past outperformance is, indeed, no guarantee of future results.



Source: Morningstar Principia

Of the six conservative funds besting the benchmark from 1999-2003, only one did so again from 2004-2008. Of the 14 balanced funds, only five subsequently beat the benchmark. Of the 11 aggressive funds, six were repeat winners.

Compared to the average index fund mix, results were similar: Of the eight conservative allocation funds beating the index fund mix from 1999-2003, only three repeated that feat from 2004-2008. Of the 17 balanced funds, seven were repeat winners. Of the 11 aggressive funds, six managed to again outperform.

On the surface, aggressive allocation funds appear attractive, since 61% outperformed the index fund mix over a ten-year horizon and 55% were repeat winners. However, my analysis does not consider taxes, and if they were considered the performance of aggressive funds would deteriorate considerably, along with that of conservative and balanced funds. Furthermore, the small sample size (11 aggressive allocation funds) argues strongly against drawing any conclusions about this fund category.

Across all risk profiles, the vast majority of “winners” from 1999 to 2003 were unable to outperform in the subsequent five years. This begs yet another question—*was their early outperformance due to skill or were they just lucky?*

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ⁱ The third shortcoming, in which Mr. Porter suggests a fairer comparison would pit the performance of two suitable index funds versus a set of the most “popular” funds used by advisors who participate in the Advisor Perspectives surveys, is beyond the scope of this paper. I believe I address Mr. Porter’s underlying concern here in the performance comparison of the “the average index fund” with “the average asset allocation fund.” The average of both groups is impacted by fees, trading costs and good/bad performers within each respective group.

*The careful reader will notice the percentage of outperforming aggressive allocation funds presented here is lower than presented in the original paper. The original paper compared aggressive allocation funds to a benchmark comprised solely of the Wilshire 5000 Total Stock Market Index. The data presented here is updated to use a different mix: 80% Wilshire 5000 Total Stock Market Index and 20% Barclays Aggregate Bond Index. I debated making this change, and ultimately made it after further research into the typical asset mix of aggressive allocation funds. At year end 2008, the average mix of aggressive allocation funds was 80% stocks, 20% bonds and cash. At year-end 2006, the average asset mix of aggressive allocation funds was 71% stocks, 29% bonds and cash. At year-end 2002, the average asset mix was 79% stocks, 21% bonds and cash. After coming to the conclusion that the typical aggressive allocation fund did hold cash and bonds consistently over time, I decided to change the benchmark comparison to a more relevant mix - 80% stocks and 20% bonds.