



The New Normal and Asset Allocation Merriman's Response

By Larry Katz, CFA
Director of Research, Merriman, Inc.
August 25, 2009

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

The following is in response to Geoff Considine's article, [What the New Normal Means for Asset Allocation](#), which appeared two weeks ago.

While we are flattered that Mr. Considine highlighted one of our recommended portfolios in his article, we have multiple objections concerning much of his logic, and would not recommend his alternative portfolio to our clients.

For some background, Merriman uses a carefully chosen collection of mutual funds from DFA and Vanguard for our clients. We advocate non-actively managed portfolios with low fees, massive global diversification, tax efficiency, a tilt towards value and small cap stocks, together with reasonable risk controls. As a service to the public, we also publish several portfolios that have generally similar characteristics.

Objections

Our major objections to the alternative portfolio include the difficulties in trying to forecast the future, the use of individual stocks, ignoring the three-factor model and underweighting international stocks. I will note several other issues as well.

Forecasting the future

Mr. Considine says he is positioning his portfolio for the "New Normal." What if that scenario does not take place? There are at least several prominent economists whose views run counter to this scenario.¹ Placing excessive reliance on any specific forecast can be risky.

We believe it is extraordinarily difficult for any forecaster, no matter how intelligent and well-placed, to accurately and consistently predict economic trends and stock market returns over time. Instead, we rely on solid academic research and many decades of

¹ Matthews, Steve. "No New Normal JPMorgan Sees V-Shaped Recovery on Robust Growth". [Bloomberg News](#). 14 August 2009.



historic evidence to structure portfolios, based on the demonstrable return premium which accrues over time to value and small-cap stocks.

Individual stocks

Mr. Considine advocates using individual stocks which are “Dividend Aristocrats.” We, on the other hand, advocate massive diversification to avoid the potential idiosyncratic risk of owning individual stocks.

This risk is easily demonstrated by looking at the Dividend Aristocrats. At the end of 2007 there were 60 companies on the list. Seven of them, or 12 percent of the total, were removed in December 2008.² These included such hard-hit financial firms as Bank of America and KeyCorp. The stock price of Bank of America fell 63 percent in 2008; if it had been chosen as part of Mr. Considine’s portfolio last year, the client would have lost nearly 2 percent from this position alone.

By contrast, our client portfolios indirectly contain over 11,000 stocks from all over the world. Our largest position in any individual stock is just over 1 percent, and our top 12 stock positions amount to only 6 percent of the portfolio, instead of the much riskier 32 percent in Mr. Considine’s suggested portfolio.

Mr. Considine’s portfolio has 19 positions (funds and stocks), while our suggested Vanguard portfolio has 12. More positions mean higher rebalancing costs.

The three-factor model

The fact that stock returns depend on three factors (Beta, small cap exposure and value exposure) is discussed in the research piece by Eugene Fama and Ken French which is cited in Mr. Considine’s article.³ We choose the funds and their weights to tilt the portfolio toward value and small-cap. We purposely include an allocation to the S&P 500 to moderate the value tilt of the portfolio.

Mr. Considine casually throws out many of our funds, dramatically changing the portfolio’s size orientation and increasing its value orientation. As measured by the three-factor model, the U.S. component of Mr. Considine’s portfolio actually has a large-cap tilt, while our portfolio has a small-cap tilt.

² Standard & Poor’s [press release](#), December 5, 2008.

³ Fama, Eugene F. and French, Kenneth R. [“The Capital Asset Pricing Model: Theory and Evidence”](#), *Journal of Economic Perspectives* Volume 18, Number 3 – Summer 2004, pages 25 – 46.



International exposure

To quote from his article, “Emphasis on international equity exposure is necessary to protect against a weaker dollar.” If that is the case, why does he reduce international exposure from 50 percent of the equity position to 24 percent (excluding bonds and commodities)? As a comparison, U.S. equities make up 43 percent of the total world capitalization, with non-U.S. equities comprising 57 percent.

Mr. Considine is giving international equities less than half their market weight in his portfolio, with absolutely no exposure to the developed international markets, even though they make up 45 percent of the world’s equities. Why does he do this when he believes that the dollar will weaken? That amounts to a very large bet against the developed countries in the world market, which adds unnecessary risk to the portfolio.

Other issues

Time horizon

With regard to our portfolio, Mr. Considine says, “the vast majority of the performance is driven by the S&P 500.” Correlations of asset classes certainly increased during the recent financial crisis, and also may have generally gone up due to increased globalization. However, correlations, and the resulting diversification benefits, can vary over time.

As an example of this, we reviewed the rolling three-year correlations of the S&P 500 with DFA’s Large Cap Value portfolio, which has return history from March 1993. The highest correlation, at 0.98, is for the three-year period ending in July 2009, which is the time frame used in his article. The lowest correlation is 0.67 for the three-year period ending August 2001. We do not believe a portfolio should be built on only three years of data; doing so adds unnecessary risk.

Utilities

Utilities are typically among the worst performing sectors coming out of a recession. Yet Mr. Considine nearly doubles his utility position relative to the market. This part of his portfolio has a high likelihood of underperforming the market once the economy stabilizes.

Inflation

We agree with Mr. Considine that it is prudent to structure portfolios to withstand inflation and that REITs can be used for this purpose. His statement that our recommended portfolio has a low exposure to REITs is puzzling, since our allocation, at 6 percent (for a 60 percent equity and 40 percent fixed income portfolio) is the same as



his. Our bond portfolio also includes an allocation to TIPs, where the principal adjusts with inflation, and also to short term bonds, where the rates will increase in an inflationary environment as the bonds mature.

Bond allocation

Mr. Considine decided to change the bond allocation from our 40 percent to 30 percent. This makes the portfolio riskier. We help our clients determine their appropriate asset allocation and risk tolerance by focusing on the actual historic losses of portfolios with different amounts of bonds (which is much more concrete and easier for clients to understand than speaking about Beta). We discuss each client's risk tolerance together with the desired returns necessary to reach the client's investment goals when choosing an appropriate asset allocation.

Conclusion

Mr. Considine's suggested portfolio has a large-cap tilt instead of our small-cap tilt. He makes several questionable bets and in so doing he arrives at a portfolio that is riskier than it needs to be.

Merriman articles on FundAdvice.com

We have written a variety of articles over the years describing our investment philosophy and favored portfolio structure. The following provides links to some of the pertinent articles:

- Paul Merriman describes our [buy and hold strategy](#).
- Please note that our [most recently published portfolios](#), which were last modified in May, are slightly different than the older recommended portfolio used by Mr. Considine.
- A quick summary of the underlying philosophy used when creating these portfolios is shown [here](#).
- An article on inflation and investments is [here](#).
- An article on bonds and inflation is [here](#).
- Dennis Tilley writes about why we don't favor [commodities](#).
- Paul Merriman writes on [asset allocation and risk tolerance](#).

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>

