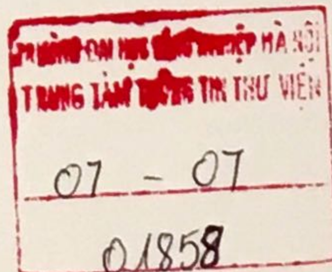
THE ART OF ASSET ALLOCATION

SECOND EDITION

Principles and Investment Strategies for Any Market

GIFT OF THE ASIA FOUNDATION
NOT FOR RE-SALE
QUÀ TẶNG CỦA QUỸ CHÂU Á
KHÔNG ĐƯỢC BÁN LẠI

DAVID M. DARST



Mc Graw Hill

New York Chicago San Francisco Lisbon
London Madrid Mexico City Milan
Montreal New Delhi San Juan
Seoul Singapore Sydney Toronto

CONTENTS

FOREWORD ix
PREFACE xi

SECTION 1

UNDERSTANDING ASSET ALLOCATION

Chapter 1

Essentials of Asset Allocation 3

Overview 3
Meanings of Asset Allocation 4
Foundations of Asset Allocation 7
The Risks and Rewards of Asset Allocation 10
Principal-Protection Assets and Principal-Growth Assets 16
The Effects of Inflation on Purchasing Power 17

Chapter 2

The Asset-Allocation Process 21

Overview 21
Matching Asset Classes with Wealth Levels and Income Needs 22
Types of Asset Allocation 24
Intersections of Asset Allocation with Other Disciplines 33

SECTION 2
THE MECHANICS OF ASSET ALLOCATION

Chapter 3
Asset-Allocation Tools and Concepts 41
Overview 41
Modern Portfolio Theory/Efficient Market Theory 42
Asset and Portfolio Returns 45
Asset and Portfolio Risk 58
Risk and Return 72
Assets' Returns and Correlations Caveats 84
Asset-Allocation Optimization Models 86
Asset-Allocation Optimization Software 93

Chapter 4
Asset-Allocation Rebalancing 95
Overview 95
Rebalancing Principles 96
Advantages and Disadvantages of Rebalancing 97
Origins and Implications of Asset-Allocation Overweighting 100
Scope of Rebalancing 106
Special Considerations Involving Concentrated Positions 108
Rebalancing Methods 115
Asset-Allocation Drift—No Rebalancing 125
Rebalancing Sensitivity Analysis 127
Critical Success Factors in Rebalancing 144

SECTION 3
UNDERPINNINGS OF ASSET ALLOCATION

Chapter 5
Individual Investor Behavior 151
Overview 151
Factors Affecting Individual Investors' Asset-Allocation Decisions 152

The Evolution of Individual Investors' Asset-Allocation Activity 153
Primary Determinants of Individual Investors' Asset Allocation 157
Strategic and Tactical Principles 162
Individual Investor Behavioral Characteristics 171
Financial Lessons from Market History 178
Insights from Behavioral Finance 182

SECTION 4

ASSET CLASS CHARACTERISTICS

Chapter 6

Distinguishing Qualities of Asset Classes 201

Overview 201
Asset Supercategories 202
Evaluating Asset Classes 204
Participants within Asset Classes 206
Asset Classes and Subasset Classes 209
Asset Class Descriptions 211
Asset Class Weightings and Uses 248

Chapter 7

Analyzing Assets' Rates of Return 255

Overview 255
Organization of Returns Data 256
Assets' Annual Rates of Return by Groups of Years 257
Assets' Annual Rates of Return by Individual Years 262
Assets' Annual Rates of Return by Economic Environment 281
Rotating Returns Leadership Among Asset Classes 291
Equities Industry Sectors by Individual Years 295
Leading Companies by Equity Market Capitalization 298
Leading U.S. Companies' Rates of Return by Individual Years 302

SECTION 5

FINANCIAL MARKETS ANALYSIS AND INVESTMENT INSIGHTS

Chapter 8

Constructing an Analytical Framework 309

Overview 309
Societal Analysis 310
Market-Cycle Analysis 312
Scenario Analysis 314
Investor Satisfaction Analysis 317
Strategy Implementation Analysis 321
Comparative Financial Analysis 324
Financial Market Climate Analysis 330
Phases and Cycles in Asset Allocation 334

SECTION 6

TACTICS AND STRATEGIES

Chapter 9

Asset-Allocation Matrices and Worksheets 339

Overview 339
Worksheets in the Asset-Allocation Process 340
Asset-Allocation Worksheets in Context 344
Drawbacks of Asset-Allocation Worksheets 346
Asset-Allocation Guidelines 347
Investors' Asset-Allocation Cycles 352
Sequencing of Market Outcomes 354
Asset-Allocation Matrices 358
Investor Profile Worksheet 359
Investment Outlook Worksheet 361
Investment Universe Worksheet 368
Risk Mitigation Matrices 374

INDEX 387

FOREWORD

The objective of investing is to increase the purchasing power of capital. This means that the total return after taxes from the portfolio must exceed the inflation rate. How high this "real" return is, and how risky the means of achieving it, are what asset allocation is all about.

Asset allocation is the most important factor in the performance equation of a multiasset portfolio. Huge amounts of time and money are devoted to the selection and evaluation of investment managers, but far less attention is paid to asset allocation. This book is designed to remedy that oversight.

David Darst and I believe that regression to the mean, or the tendency of returns to gravitate toward their long-term averages, is one of the most powerful forces in investing. Any asset allocation process must have an abiding respect for history. As Winston Churchill said, "the farther backward you can look, the farther forward you can see."

Brinson, Singer, and Beebower have published several scholarly studies in *The Financial Analysts Journal* on the determinants of portfolio performance. They found that differences in allocation policy accounted for 91.5% of the variations of returns across a sample of 82 large, multiasset U.S. pension fund portfolios from 1977 to 1987. An analysis by SEI of 97 large pension funds showed that 87% of differential performance was related to asset class selection. A Hamilton Johnson study demonstrated that by correctly alternating between stocks, bonds, and cash, over 10 years, annual returns three times those of the typical balanced fund can be realized.