INVESTMENT UPDATE
NEWSLETTER

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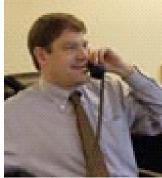

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Revisiting the Basics: Strategic asset allocation

Forgive my opening with a tautology, but *anyone who owns assets has an asset allocation*, a particular exposure to various investment types (or for the utterly undiversified, a single type). Whether or not they intend to have the allocation they do is another matter; unfortunately, for many investors, the proportions are incidental or even accidental.

At Allen Trust and Allen Capital Management, we believe it essential to be intentional, to specify what percentage of your portfolio should be exposed *in the positive sense as well as the negative* to different asset types… for over time, these exposure choices will dominate both the returns your portfolio achieves and the shocks it endures along the way. The big decision – how much to put into stocks, how much into bonds or real estate or cash etc. – will trump the impact of individual security selection.

Part of that "big decision" is not simply the allocation targets themselves, but the time horizon underlying them and the direction in which the portfolio is rebalanced over time. Here, we normally practice *strategic* asset allocation, whereby the implicit time horizon is long, and the periodic rebalancing aims to restore the portfolio *toward* its long-term targets. In contrast, *tactical* asset allocation (not our core approach) implies a shorter time horizon and may incorporate ad hoc rebalancing methods that move the portfolio intentionally *away from* its initial targets.

Our strategic approach seeks to be stable, which can mean foregoing gains in a hot asset class the further it bulls onward, with the notion that there will be a compensating relief of pain when that sector turns down and shoots below trend (remember – and forgive me perhaps a second tautology – *every series makes half its movement below its long-term mean*).

Fundamental to our strategic approach are the following: 1) markets eventually swing back toward trend (i.e. they're mean-reverting), and 2) the timing with which they do so is not consistently predictable. The first assumption drives our rebalancing approach: as one asset class outperforms its historical trend and another one underperforms, we periodically take money "off the table" in the former and put it to work in the latter. Over long periods, this becomes a structural method of selling higher and buying lower.

Skepticism and humility are part of this. We are skeptical of the broad market's enthusiasms and its aversions alike, lest the former lead us to buy into bubbles and the latter to sell out at bottoms. And given assumption (2) above, we're humble in that we don't believe we can pinpoint major turns in the market – we can't know when a mania will peak, or a bear market trough, so our asset shifts are incremental rather than wholesale.

Though long-term trends may be apparent, how they will play out in the short run is unknowable. While I can predict with a high degree of confidence that Portland's summer in 2017 will be warm, I can only guess whether Tuesday after next will be rainy or dry. Likewise in markets: I have no idea whether stocks will rise or fall in March, but history makes me confident they'll be up in a decade. Our strategic allocation approach attempts explicitly to recognize this *hyperopia*, this inability to see clearly what is a short way out on the calendar as well as we see the broad shape of things at distant horizons.

And it can pay off. Despite misgivings coming into 2006, we kept to target and did not sell out of the stock market. Of course, having benefited from that 15% rise, we must now rebalance away again.

In future letters I will discuss the challenges of this strategic approach, and explore whether *abnormal* market conditions may justify deviating from it.

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