**The Economist:** No easy answers

**The conundrum of asset allocation**

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NOBODY knows anything. William Goldman said that about the movie business but the same could be said for investment. History is replete with brilliant people who made calamitous mistakes.

Some of the finest minds on Wall Street and in academia were behind Long-Term Capital Management (LTCM), a hedge fund that collapsed in 1998, after following a strategy that believed the market was underpricing illiquid assets and overpricing liquid ones, using squillions of borrowed money. As Warren Buffett said at the time: “To make the money they didn’t have and didn’t need, they risked what they did have and did need.”

Even the “self-evident truths” that are often spouted about investment—buy low, sell high; rebalance regularly; diversify your portfolio—are either overly simplistic or difficult to follow in practice, as a fascinating [new book](http://www.amazon.com/Rational-Expectations-Allocation-Investing-Adults-ebook/dp/B00KSPCY24) by William Bernstein, an investment adviser (and neurologist), makes clear.

Take buying low and selling high. It sounds good. But it is tough to buy (or indeed, not to sell) when markets are plunging and all around are panicking. Wall Street bottomed in 1932 but the market had been falling since 1929; there were few investors left with the cash or the confidence to buy. Even professional fund managers find it hard to buy at the bottom. They lose clients when markets fall, so at the very moment when future returns are highest they have less money to put to work.

The answer, some say, is to rebalance the portfolio automatically as some investments appreciate and others lose value to maintain the original allocation. But that doesn’t always work. Imagine that in 1990 you had a portfolio split 50/50 between American and Japanese equities. After each year, you rebalanced the portfolio; by 2009 you would have earned an annual return of 3.64%. But had you not rebalanced, the annual return would have been 5.16%. That is because Japanese equities were trading on stratospheric valuations in early 1990 and subsequently suffered a 20-year bear market.

Starting valuations matter hugely for future returns. That is obvious for those buying, say, German bonds on a current yield of 1.2%. But equities are trickier. In retrospect, buying stocks when the cyclically adjusted price-earnings ratio was high, or the dividend yield was low, results in low long-term returns. But investors do not know what the future range of such valuations will be. An experiment by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School found that following such a strategy using historical dividend yields would have been worse than simply buying and holding equities.

To get round these problems, investors have been urged to diversify. The fad for the past 50 years has been portfolio optimisation: choosing assets based on their expected return, their volatility and their correlation with other assets. The problem is that these factors are not set in stone; indeed, the very pursuit of optimisation can alter the fundamentals.

Take commodities, which used to offer a “roll yield” to investors: the futures price tended to be below the spot (current) price, so buying the future and holding it delivered an automatic return. But so many investors piled into commodities that the roll yield disappeared. Emerging markets have been another big hope, based on their rapid growth. But that does not automatically translate into higher returns, as investors in China have discovered (see chart).

The best thing investors can do, Mr Bernstein suggests, is be realistic. The returns on capital have been falling for centuries, perhaps because people are less impatient (thus willing to accept a lower price for deferring consumption) or maybe because society has become less risky.

As well as low bond returns, future equity returns are likely to be lower than investors have become used to. The future return is equal to the current dividend yield, plus dividend growth, plus or minus any change in valuation. Historically, dividends have grown by 1.5% a year in real terms. Combine that with a dividend yield of 2.1% and you get an expected real return of 3.6%. But if the market returns to its historic average valuation, the return will fall to 2%.

Such returns are still worth pursuing, as long as investors remember the case of LTCM and do not get too greedy. As Mr Bernstein concludes: “The purpose of investing is not to simply optimise returns and make yourself rich. The purpose is not to die poor.”