The Case for Asset Allocation

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A 2007 survey by Rochdale Investment Management taken before last fall's dramatic downturn in the stock market showed the primary concern for high-net-worth clients was wealth preservation.[1] To that end, a key investment strategy for wealth preservation is diversification; however, being diversified doesn't simply mean owning a broad array of securities.

Last year, diversification across equity styles helped little, as losses for U.S. stocks exceeded 30 percent from small cap to large and from growth to value. International stocks performed even worse. In fact, homogeneity among various equity styles increased substantially during the recent bear market period.

When constructing a portfolio that is designed to preserve one's wealth, correlation is a critical consideration. According to Nobel Prize-winning economist Harry Markowitz, the father of modern portfolio theory, combining securities that do not have high correlation to one another can reduce risk without sacrificing return.[2] A recent study by Goldman Sachs shows that despite a tightening of correlations during the recent bear market, lower correlations remain the rule longer-term.[3]
Bonds offered substantial harbor during the recent storm, producing positive returns from late 2007 through early 2009. As bad as 2008 was, an investor with a $10 million account equally allocated between stocks and bonds at the bull market peak in 2007 would have lost $1.5 million by the end of last year, as compared to losing $3.9 million for an investor who only owned stocks.

How important is asset allocation? Studies have shown that as much as 90 percent of the variability of an investment portfolio's returns can be explained by it assuming adequate diversification in the underlying asset classes. Creating an asset allocation to match risk tolerance and return requirements is critical to maximizing risk-adjusted returns. Equally important, investors should stick with their investment strategy and make changes only as critical inputs such as income needs, risk attitudes and time horizon dictate—not in reaction to market trends.

As bad as 2008 was, stocks remain a key asset class for building long-term wealth. From 1825 to 2008, stocks have risen in 129 of 184 years, or 70 percent of the time. By combining a diversified equity portfolio with low correlation bonds, real estate and cash—high-net-worth investors will be well prepared to weather the inevitable, periodic storms that buffer the economy and the stock market.

Jim Rudd has been with Ferguson Wellman Capital Management for 25 years and currently serves as the firm's CEO. Rudd also serves as board chair of the Federal Reserve Bank of San Francisco Portland Branch. Founded in 1975, Ferguson Wellman is a privately owned investment advisory firm, established in the Pacific Northwest. With more than 500 clients, the firm manages $2.1 billion in assets for high-net-worth individuals and families as well as institutional clients with portfolios of $2 million or more. (3/31/09)

(Footnotes)
1 Rochdale Investment Management, Private Client Survey, 2007.
2 Ronald Delegge, "Theorizing Risk with Harry Markowitz," Research Magazine, December 31, 2008.
3 Goldman Sachs, "Building Better Portfolios Using a Core and Satellite Approach," 2009.

Primary Asset Classes	Correlation 10/07 – 12/08	Long-term Correlation
Domestic stocks (S&P 500)	1.00	1.00
International stocks (MSCI EAFE)	0.91	0.78
U.S. bonds (Lehman/Barclays Aggregate)	0.33	-0.05
U.S. real estate (REITs)	0.80	0.42
Cash	-0.12	0.00

Source: Goldman Sachs