

# The Secrets of Asset Allocation

**In this Special report you will learn:**

- **Wall Street's Only Free Lunch-The Portfolio Secret That Won the Nobel Prize**
- **How to Determine Where to Put Your Eggs (Not in One Basket)**
- **The Ins and Outs of Risk**
- **Proper Portfolio Management**

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Harry Markowitz, the Nobel Prize winning economist, is widely credited with turning the field of investing into a science, not just an art. In his benchmark article entitled “Portfolio Selection” published in the 1952 *Journal of Finance*, he correctly identified and quantified the power of asset allocation. Among the most important of Harry’s revolutionary findings was that specific investment selection accounts for less than 5% of the final success of a portfolio, yet over 95% of the portfolio’s final success is created by the correct asset mix, which is the allocation of the portfolio contents among the various asset groups. Your portfolio must make sense in the context of this overall asset allocation. The proper allocation for each individual will differ depending on long or short-term goals and level of risk tolerance.

The concept behind proper asset allocation is the avoidance of the confusion and emotions of the day-to-day headlines about fluctuations in the stock market. When investors become confused or lose perspective, chances of profit diminish greatly. Investment success requires discipline, and discipline emanates from the reliability of the investor’s plan and its chances of success over time.

For most people, asset allocation is critical for building a successful investment strategy. In simple terms, it involves spreading your assets among several different investment options. Asset allocation can help you minimize risk in your portfolio when market conditions are uncertain and can increase your long-term potential for returns.

**Wealth Principle #1** - The essence of asset allocation is spreading the risk without diluting the potential for gain.

Asset allocation succeeds because it accounts for the fluctuations in asset value and return caused by: (1) the cyclical nature of most investments, and (2) the inter-relationship of asset fluctuations within the cycles. It is very much like the seasonal retailer who sells lawn and garden materials in the spring and summer, then totally revamps the sales floor and advertising to sell Halloween and Christmas decorations in the fall and winter.

Asset allocation also involves dividing an investment portfolio among different asset categories, such as stocks, bonds, real estate, gold, and cash. Mixing the asset categories spreads the risk of cyclical and other fluctuations among different categories. The different categories in your asset mix tend to react to the cycle or display fluctuations in a non-uniform fashion, and as a result, are often counterbalanced by one another.

For example, we have all seen the relationship between the price of stocks and Treasury bonds. Sometimes when stock prices go down in a bear market, investors seek the safety of Treasury bonds. By having both stocks and bonds allocated in your portfolio, you may see less volatility than if you held all of your assets in either one group or the other.

In summary, investors use asset allocation to protect against significant losses by including asset categories with investment returns that move in opposite directions. Historically, the returns of the three major asset categories (stocks, bonds and cash) have not moved in the same direction at

the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns. By investing in more than one asset category, risk is reduced, and overall investment returns are less volatile. The fall of one asset category can be counterbalanced by better results in another asset category.

**Wealth Principle #2** - Time and Risk are more important factors to sustained wealth than individual security performance.

The process of determining which mix of assets to hold in your portfolio is very personal. The asset allocation that works best for you at any given point in your life will depend largely on your individual time horizon and your ability to tolerate risk. This principle can be identified as follows:

- Time – The length of time that you will be investing to achieve a particular financial goal is an essential factor in determining what asset allocation mix to choose. An investor with a longer time horizon may be more likely to compose the allocation to favor higher risk investments because he or she can wait out slow economic cycles and the inevitable ups and downs of our markets. On the other hand, a person looking for a very short term return would likely favor less risk because of the shorter time available to cyclically adjust.
- Risk Tolerance - Risk tolerance measures the ability and willingness to lose some or all of your original investment in exchange for greater potential returns. The higher the risk the higher the potential return and the greater the chance of loss. Conservative investments or one with a lower risk tends toward investments that will preserve his or her original investment, with the accompanying lower, albeit more certain, return.

Time and risk tolerance are both measurable. The way that investment scholars measure risk and its effect over time is through the vehicle of past analysis. That is, past performance is analyzed, quantified and measured over varying time periods in order to determine how a particular investment or investment class performs, and then applying that past performance as a future predictor. While this is a simplification of a very sophisticated mathematical model, the results are nonetheless illuminating and provide valuable guidance for the asset allocation most suited to you.

**For example, compare the performance of three distinct asset allocation mixes composed of stocks and bonds (as of December 2005):**

	<b>100% Stocks 0% Bonds (Riskiest)</b>	<b>80% Stocks 20% Bonds (Moderate)</b>	<b>60% Stocks 40% Bonds (Safest)</b>
<b>20 Yr Average Return</b>	<b>11.79%</b>	<b>11.29%</b>	<b>10.79%</b>
<b>Single Best Year</b>	<b>56.50%</b>	<b>50.56%</b>	<b>44.62%</b>
<b>Single Worst Year</b>	<b>-26.13%</b>	<b>-18.31%</b>	<b>-10.49%</b>

Source: Lipper. Stock investments are represented by equal investments in the Russell 1000, Russell 2000 and MSCI EAFE Indexes, representing large U.S. stocks, small U.S. stocks and foreign stocks, respectively. Russell 1000 Index measures the performance of the largest companies in the Russell 3000 Index. Russell 2000 Index measures the performance of the 2000 smallest companies in the Russell 3000 Index. Bonds are represented by the Lehman Brothers Aggregate Bond Index. Lehman Brothers Aggregate Bond Index is made up of a representative list of government, corporate, asset-backed and mortgage-backed securities. Cash is represented by U.S. Treasury Bills. These indexes are unmanaged and you may not make an investment in these indexes. Past performance is no guarantee for future returns.

Asset allocation is important because it is not enough just to reduce risk or to take an extra chance to meet your goal. Observe that if you don't include enough risk in your portfolio, your investments may not earn a large enough return to meet your goal. Conversely, if you include too much risk in your portfolio, the money for your goal may not be there when you need it. To take advantage of the benefit of asset allocation, there must indeed be an allocation.

**Wealth Principle #3** - The major asset categories are already well established.

Stocks, bonds, and cash are the most common asset categories. Other asset categories include real estate, precious metals, and private equity investments.

Stocks - Stocks have historically had the greatest risk and highest returns among the three major asset categories. Stocks hit home runs, but also strike out. They are very risky in the short term but, if you are willing to ride out the volatility, over long periods of time you will generally be rewarded with strong positive returns.

Bonds - Bonds are generally less volatile than stocks but offer more modest returns.

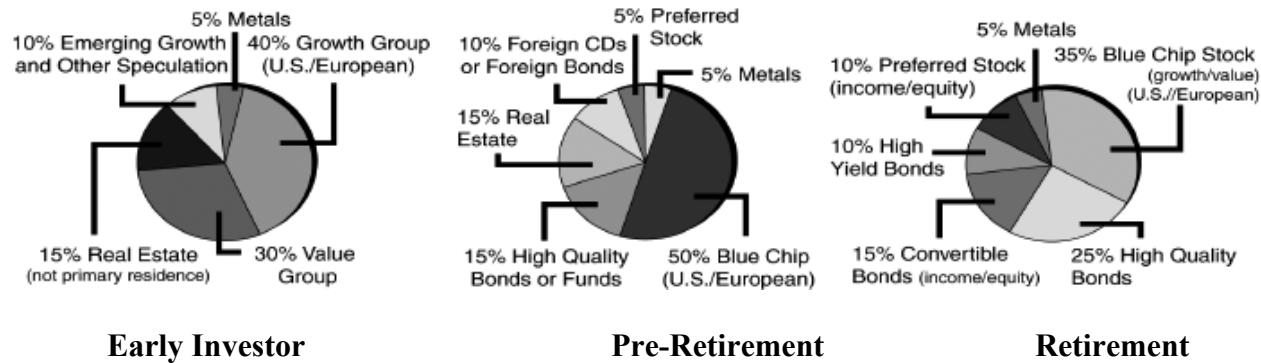
Cash - Cash and cash equivalents - such as savings deposits, certificates of deposit, treasury bills, money market deposit accounts, and money market funds - are the safest investments, but offer the lowest return of the three major asset categories.

Real Estate – Real estate is perhaps the most cyclical of all investments, demonstrating long periods of increase followed by long periods of fall and then back, always, in the very long run, tending upward.

Metals & commodities – Metals and commodities have proven the most speculative of investments because they typically are held for very short periods, especially commodities that actually deteriorate over time (like food, such as Orange Juice or Corn).

#### Wealth Principle #4 - Begin Asset Allocation now!

Note the following pie charts (Source: Adriane G. Berg, Wealthbuilder Newsletter, 1998-2002):



Depending upon your position in life, the Early Investor, the Pre-Retirement Investor or the Retirement Investor Model is a good starting point. The goal is to move your assets toward an allocation roughly in accord with one of these diagrams. You may find that thus far you have met your investment goals, or you may discover that your allocation needs to be adjusted (again, based on your own risk tolerance or timeframe). That adjustment entails selling some investments and replacing them with others. This is called "reallocation," and here are the steps to follow:

- 1) List the four main asset categories of cash, income, equities and speculation. Write the amount of money you have invested in each of these respective categories.
- 2) Turn the dollar amounts into percentages, so your entire portfolio is equal to 100%. It is preferred that you use percentages. That is because it helps you unfocus on how much money you have saved, wasted, earned or could earn, and instead envision the parts of the whole.

Moreover, asset allocation models are all expressed in percentages, so you will need the same form for comparisons.

### **Wealth Principle #5 – The essentials of diversification.**

3) Diversification is commonly referred to as microallocation. Diversification is the strategy that admonishes: "Don't put all your eggs in one basket." One of way of diversifying your investments within an asset category is to identify and invest in a wide range of companies and industry sectors. Investing in only a handful of stocks may not create a truly diversified portfolio.

Here are some diversification tips:

*By company size:* Within each of the broad asset categories are subcategories. For example, stocks break up into different capitalizations called small cap, large cap, micro cap, and mid cap. Those can be further broken down up to reflect other variables, such as earnings, industry group, cash and debt.

*By growth and value:* Historically some companies react differently to changes in the general market than others. For example, undervalued companies tend to rise faster (both absolutely and relatively) than others. By the same token, companies with high earnings and lower relative prices tend to take less of a fall (again both absolutely and relatively) when the market corrects. The lesson we learn is that we must diversify between the two groups and allocate our holdings among the undervalued, the high yielders and the mixed.

*By sector:* Different industry groups react in their own distinct way to changes: fluctuation in interest rate, good/poor economic news, politics, etc. Armed with this information, we must diversify to account for it. We must micro allocate so that all of our holdings do not react the same way to inevitable changes.

*By interest rate sensitivity:* Aside from political, economic or natural disasters, the one factor that drives the market up and down is interest rates. Looking for the best return on their dollar, investors gravitate to the market when interest rates are down and flee when they believe they can do better in bonds or cash. At Channel Capital Research we use interest rate changes not to flee the market, but to make better choices. Companies that do not need credit because of good, positive cash flow will not respond as drastically to interest rate increases as those that need credit to thrive. Similarly, companies with large growth ratios or small cash flow will also react differently to interest rate changes than those with low credit usage or high cash flow.

4) Review your list of holdings. Is anything missing from your allocation? Further analyze where your portfolio is "top heavy." For example, thirty percent of a portfolio in speculation is very high risk. Thirty percent in cash is hardly a wise choice and may not outpace inflation.

## **Wealth Principle #6 – Rebalance your portfolio regularly.**

Over time, some assets grow while others shrink, and an allocation based on percentages may no longer hold to the original ratios. Your own time needs may also dictate a review of your asset allocation. Because of this, asset allocations should be revisited and revised regularly, at least annually.

Savvy investors typically do not change their asset allocation; instead, they "rebalance" their portfolios.

Rebalancing is bringing your portfolio back to its original asset allocation mix because, over time, some of your investments may become out of alignment from the original allocation. Rebalancing prevents your portfolio from overemphasize one or more asset categories and returns it to a comfortable level of risk.

For example, let's say your allocation for stock investments should represent 60% of your portfolio but, because of a recent market drop they represent only 40% of your portfolio. Rebalancing will call for either the purchase of additional stock or the sale of the now over weighted categories.

But remember, the asset allocation you originally chose was selected for the long run. Rebalancing, therefore, should keep this in mind and should not be undertaken too often. When you rebalance, review the investments within each asset allocation category and determine if any categories are out of alignment. If so, make changes to bring them back to their original allocation within the asset category.

There are many methods for portfolio rebalancing, but these are the most common:

1. Sell from over-weighted asset categories and use the proceeds to purchase investments for under-weighted asset categories.
2. Purchase new investments for under-weighted asset categories.
3. If you are making continuous contributions to the portfolio, change your contribution ratios until your portfolio is back into balance.

Before you rebalance your portfolio, you should consider whether the method of rebalancing you decide to use will trigger transaction fees or tax consequences. Your financial professional or tax adviser can help you identify ways that you can minimize these potential costs.

Finally, an alternative is to change your asset allocation target to match changing economic conditions. Research shows that certain asset classes perform better when specific economic indicators move one way or the other. This method is called Tactical Asset Allocation.

Tactical Asset Allocation is the basis for our Follow the Fed Strategies, as well as our more advanced Twin Foundations and Hedge Fund Tool Box strategies.

You can read more about them at [www.ChannelCapitalResearch.com/FollowtheFed](http://www.ChannelCapitalResearch.com/FollowtheFed).

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## Praise for *Follow the Fed to Investment Success*

*"This is a great strategy for investors who actually have a job, a family and interests – in other words, a life."*

**Randall W. Forsyth – Editor, Barron's Online**

*"The Follow the Fed strategies defy the rules of conventional investing, and they work! Doug Roberts is right when he says we sometimes make investing way too hard. He has demonstrated that amazing returns that beat the market by large amounts can be made with only a trade or two a year. I recommend these strategies without reservation to anyone who wants to achieve superior returns while reducing the stress associated with investing."*

**Hilary Kramer - AOL / Finance Editor and Market Strategist**

*"When it comes to investing, Doug Roberts is the man to know. With his background at Wall Street firms like Morgan Stanley and Sanford Bernstein, he has learned all the tricks that allow those guys to literally print money. Now with his 'outside the box' way of thinking, he has a system that allows ordinary guys like me to get a piece of the action usually reserved for Wall Street insiders. The best thing of all is that I do not have to watch the market every day. I leave that to experts like Doug."*

**Eddie Hittinger, MD**

**Cliffside Park, New Jersey**

*"I have known Doug Roberts since his days at the Wharton School and have always considered him one of the smartest people I know. I have watched his rise through Wall Street. Over the years he has been kind enough to share his investing philosophy with me. These recommendations would have made me very rich, but I never had the minimums necessary for him to manage my money. Now Doug has developed a system that allows investors like me to invest like him, and I am jumping in with both feet."*

**Howard M. Gitten, Attorney**

**Fort Lauderdale, Florida**

*"Doug Roberts has been a lifetime member of the worldwide CEO Clubs for as long as me, and I am the founder.... Today, his business has blossomed because his wealth creating advice has made him a sought after expert on a topic most CEO's do poorly managing...Creating Their Own Wealth!!"*

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**CEO Clubs Worldwide**

**New York, New York**

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**Barry Flanagan**

**Tap Consulting, L.L.C.**

**Granger, Indiana**

## Doug Roberts

### Biography



Douglas S. Roberts is the Founder and Chief Investment Strategist for the Channel Capital Research Institute. He is a Contributor to AOL's Money & Finance section and is frequently called upon by the media as an expert on the Federal Reserve Bank. His comments appear regularly on CNN/Money, MarketWatch.com, Reuters, and the Dow Jones Newswires, and he is a frequent guest on CNBC and the Fox Business Channel. Doug's new book, *Follow the Fed to Investment Success*, was published by John Wiley & Sons in May of 2008.

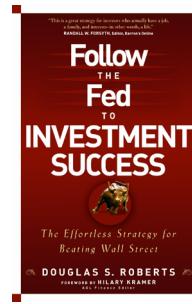
Doug was a Vice President and Portfolio Manager at Bernstein Investment Management and Research, a unit of Alliance Capital Management, L.P., from 1999-2001. In addition to his portfolio management responsibilities, he led his group's strategies focusing on quantitative investment analysis and sector allocation, as well as the evaluation of alternative asset investment vehicles.

From 1994-1998, Doug was a Managing Director of the Roberts Mitani Group, a New York merchant bank specializing in the investment of capital from Japan and East Asia. From 1992-1994 he served as a founding member of the Board of Directors of Benson Eyecare Corporation, which had been listed on the American Stock Exchange prior to its sale.

From 1985-1992, Doug was the Chief Operating Officer of the Flori Roberts/Dermablend Group, a family-owned pharmaceutical/cosmetic group of companies that were acquired for \$22 million in cash and stock by IVAX Corporation (IVX-ASE) in 1992. Subsequent to the acquisition, he served as Chief Operating Officer of the Personal Care Products Group and Assistant to the Chairman-Special Projects from 1992-1994.

Doug began his career as an Associate of the Morgan Stanley Group working in the Corporate Finance department in both the New York and London offices from 1983-1985. He earned a B.S. and an M.B.A. from the Wharton School at the University of Pennsylvania in 1983.

He serves on the international Board of Governors of Sigma Phi Epsilon fraternity and the Board of Trustees of the Ranney School and is a member of the Explorers Club for his participation in the discovery of the U-869, a World War II German submarine, off the coast of New Jersey as featured in the book, *Shadow Divers*. He holds a second-degree black belt in the Imperial system of tae kwon do. Doug is married with two children.



\*\*Special Bonus Report Data were obtained from the Kenneth R. French, PhD - Data Library (<http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/index.html>) and Standard and Poor's ([www.standardandpoors.com](http://www.standardandpoors.com)). Market indices include dividends except where noted. Actual live signals issued from ChannelCapitalResearch.com were used since 2006.

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