Designing Your Portfolio Pt 5–Putting Together the Asset Allocation

In part 3 of this series, we discussed how to choose asset classes to include in your portfolio. In part 4, we listed dozens of possible asset classes you could include. At this point, you have hopefully decided which asset classes you’d like to include in your portfolio. But how much of each one should you include?

There is No Right Answer

This process can be very personal because there really is no single right answer. There probably isn’t even a single right answer for you. There are literally hundreds of reasonable asset allocations that, combined with a reasonable savings rate, will allow you to reach your financial goals. So don’t worry too much about getting this step perfectly right. Besides, portfolios that are only slightly different only perform slightly differently. Perfect can be the enemy of good here.
5  Considerations For Putting Together Your Asset Allocation

#1 The All-Important Stock to Bond Ratio

A portfolio is traditionally composed of risky stocks and relatively riskless bonds. The ratio between these two is the most important factor determining both the risk and the return of your portfolio and is the first thing to decide when putting your asset allocation together.

John Bogle’s rule is that your stock allocation percentage should be approximately 100% minus your age. So if you’re 25, you should have 75% stocks. If you’re 75, you should have 25% stocks. While no rule of thumb should ever be hard and fast, and there are plenty of good reasons to not follow this rule, if you’re not sure where to start, this is a great place.

Some have argued for as much as a “120 minus your age” rule, but I’ll be honest, when I start seeing people advocating this it usually is after a long run-up in stocks, and shortly before the beginning of a bear market. That would put a 50-year-old at 70% stocks, which is probably a little on the aggressive side. I have two pieces of advice for you when deciding on your stock to bond ratio.
First, Benjamin Graham suggested you should never have more than 75% of your portfolio in stocks, nor less than 25% of the portfolio in stocks. Warren Buffett claims that everything he knows about investing he learned from Benjamin Graham. I suggest you listen to those two. Your portfolio is not the place to be an extremist.

#2 Risk Tolerance

Second, when you are first developing your portfolio, I suggest you be more conservative than you think you should until you pass through the fire of a bear market the first time to see how you react. The worst possible outcome for a portfolio is for you to sell low during a bear market just before your retirement. I have two colleagues who did just this. Guess what? They’re still working shifts.

The time to learn your true risk tolerance is not during the last bear market before your retirement. It’s during the bear market you go through in your 20s or 30s. During the bear market of 2008-2009, the US stock market declined over 56%. Other asset classes, such as emerging market stocks and REITs lost even more. The US stock market declined approximately 90% during the Great Depression. You should expect to lose at least half of the money you have invested in stocks 2-3 times during your investing career.

That means at least a 25% loss on a 50/50 portfolio. If you’ve never watched several years worth of savings evaporate before your eyes, you don’t know what it feels like in your gut to go through that. DO NOT overestimate your risk tolerance. It is far better to underestimate it. You can always ramp up the risk after your first bear market managing your own portfolio if you find you can tolerate it. In my experience, it is far more common for people to take on more risk than they can handle, and most end up buying high and selling low.
#3 How Much International Stock Exposure?

Another difficult question a portfolio manager (you if you’re managing your own) is how much of the portfolio you should expose to the unique risks faced by international stocks, including currency risk. There are lots of good reasons to invest internationally, including significant diversification benefits and the possibility of outstanding returns in many countries.

I personally recommend you invest at least 20% of the money designated for stocks in your portfolio in stocks of countries outside your home country. In my opinion, the maximum you should invest in international stocks is the market weight, which is currently about 55% of your stocks. Any number between those is reasonable.

#4 Total Market Approach Versus Tilting

One very reasonable way to invest is to just buy all the stocks and all the bonds. For example, you could design a portfolio that is 1/3 Total Stock Market Index (US Stocks), 1/3 Total Bond Market Index (US Bonds), and 1/3 Total International Stock Index (Non-US Stocks.) This has many benefits, including ultimate diversification, very low costs, and simplicity.
However, there are also good arguments for “tilting” the stock portions of your portfolio to riskier assets. That means holding MORE than the market weights of riskier assets such as value stocks, small stocks, junk bonds, and emerging market stocks. The hope is that you’ll have higher long-term returns to compensate you for taking the additional risk.

An example of a tilted portfolio would be 25% Total Stock Market, 10% Small Value, 25% Total International Stock, 10% Emerging Markets, 25% Total Bond Market, and 5% Junk Bonds.

**How much to tilt?**

Once you’ve decided you WANT to tilt your portfolio to some riskier asset class, you’re left with the decision of how much to tilt it. The more you tilt, the more theoretical return you will get, but you have to weigh that against the loss of diversification and the additional risk. The reason small stocks have a higher expected return is that the risk is higher that they may not get that expected return, even in the long run. It’s a bit of a Catch-22.

I suggest moderation in all things. Although some authorities have advocated putting all of your stock allocation into risky asset classes such as small value stocks, I recommend you keep your tilts small enough that you still have a significant chunk of your portfolio invested in all the stocks in the world and all the investment grade bonds in your currency.
#5 Splitting Up Fixed

Some investors also like to “slice-up” their fixed income allocation. The smaller your stock to bond ratio, the more important this issue becomes. I suggest you keep some portion of your fixed income in investment grade nominal bonds or their equivalents (CDs or perhaps the TSP G Fund) and some portion in bonds indexed to inflation, such as TIPS. The percentages I leave up to you. If your bond allocation is relatively small, and you want to keep it simple, there’s nothing wrong with putting your entire fixed allocation into a total bond market fund.

Examples

As I mentioned above, there are dozens, perhaps hundreds, of reasonable asset allocations. I’ve outlined a number of popular ones here previously. The most important thing really isn’t the specific portfolio you choose. The important thing (once you choose a reasonable portfolio) is that you stick with it through thick and thin, modifying it rarely, only for very good reasons, and after giving it great thought over a period of months. But for the novice asset allocator, I will provide 3 examples of portfolios I consider reasonable, as well as 5 portfolios I do not consider reasonable.

Reasonable portfolio # 1  Relatively aggressive, with a tilt to small and some alternative asset classes

- US Stock Market  20%
- Small US Stocks  10%
- International Stocks  20%
- Small International stocks  10%
- Gold  5%
- REITs  5%
- TIPS  15%
- Total US Bond Market  15%
Reasonable Portfolio # 2
Conservative and Simple

- US Stock Market 30%
- International Stocks 10%
- TIPS 10%
- Total Bond Market 40%
- Cash 10%

Reasonable Portfolio # 3  The portfolio of an asset-class junkie

- US Stock Market 20%
- Small Value Stocks 10%
- International Stocks 10%
- Small International Stocks 5%
- International Value Stocks 5%
- Precious Metals Stock Fund 5%
- REIT Fund 5%
- TIPS 15%
- Total Bond Market 15%
- Junk Bonds 5%
- Cash 5%

Unreasonable Portfolio # 1  Extreme, lacks diversification and/or lacks growth potential

- Gold 60%
- Cash 20%
- Guns and Ammo 20%

Unreasonable Portfolio # 2  Lacks diversification due to no low-risk asset classes

- Total Stock Market Index 100%
Unreasonable Portfolio # 3  Too much international tilt

- Total International 50%
  - US Stocks 25%
  - Bonds 25%

Unreasonable Portfolio # 4  Bizarre, huge tracking error, lacks diversification.

- REITs 25%
- Gold 20%
- Silver 20%
- Transportation Stocks 15%
- China Stocks 10%
- Israeli Stocks 5%
- Mid-Cap Growth Stocks 5%

Unreasonable Portfolio # 5  Too complicated and slices are too small

- US Large Growth Stocks 3%
- US Mid-cap Growth Stocks 1%
- US Small-cap Growth Stocks 3%
- US Large Blend Stocks 3%
- US Mid-cap Blend Stocks 3%
- US Small Blend Stocks 3%
- US Large Value Stocks 2%
- US Mid-cap Value Stocks 3%
- US Small-cap Value Stocks 2%
- Microcaps 3%
- REITs 3%
- International REITS 3%
- Large International Stocks 3%
- International Growth Stocks 4%
- Emerging Market Value Stocks 5%
- China Fund 3%
- Small International Stocks 3%
- Gold 2.5%
- Silver 2.5%
- Copper 1%
- Platinum 1%

Employer’s Stock 5%
- TIPS 4%
- Short-term Treasuries 6%
- Short-term corporates 7%
- Long-term treasuries 8%
- Junk Bonds 3%
- Peer to Peer Lending 2%
- Energy Stocks 4%
- Commodities Fund 4%

Next time we’ll discuss how to implement the asset allocation, by choosing actual investments in order to arrive at your desired allocation. The series continues with Part 6 here.