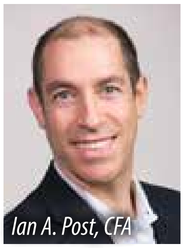
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Asset Class Returns: The Ultimate Cliffhanger

By Ian A. Post, CFA, CFP®

A few weeks ago, a client and I were reviewing asset class returns for the year when we began discussing the underlying reasons for always owning every major asset class, an investment approach called strategic asset allocation[1].

Implementing a strategic asset allocation approach ensures an investor always has exposure to the best performing asset classes. It also ensures the investor always has exposure to the worst performing asset classes. This begs the question, "why adopt a strategy that ensures ownership of the worst performing asset classes every year"? The answer is that strategic asset allocation offers the best of a bad set of options when designing portfolios. It addresses the underlying problem we face when designing portfolios which is that we don't know which asset classes will perform well in the next year and which ones won't.

To highlight the issue, let's go back in time to the end of 2015. At the end of the day on December 31st 2015, we review the best and worst performing asset classes for the year. The winners were Municipal Bonds[2] (3.3%), Real Estate Investment Trusts (REITs[3]) (2.8%) and Large U.S. Stocks[4] (1.4%). The losers were Emerging Market Stocks[5] (-14.6%), Small U.S. Stocks[6] (-4.4%) and International Developed Stocks[7] (-0.4%). Investors are naturally drawn to the best performing investments so one idea for creating a portfolio for 2016 might be to form an equal weighted portfolio of the top three performing asset classes from 2015. A "winner" portfolio based on that approach would place one third of the portfolio value in each of Municipal Bonds, REITs and Large U.S. Stocks. For comparison purposes, we could also form a portfolio based on the losers from 2015. The "loser" portfolio would include one third in each of Emerging Market, Small U.S. and International Developed Stocks.

Now, let's bolt ahead to late December 2016[8]. How did our portfolios do? The "winner" portfolio gained 6.6% YTD. Not bad.

And the "loser" portfolio? That was up 10.4%!

Amazingly, the portfolio composed of the worst performing asset classes from 2015 returned almost twice that of the best performing asset classes from the prior year.

Why does this happen? We see this kind of result because security returns are mostly random over short periods of time. Good or bad returns in one period tell you nothing about asset class returns in the next period.

This leads us back to the case for utilizing strategic asset allocation. A portfolio designed with exposure to all major asset classes *at all times* ensures that you won't miss out on the year's big winner (U.S. Small Stocks in 2016, up 21.7%). Strategic asset allocation benefits also include low trading and tax costs as well as a consistent exposure to market risk. Without a crystal ball to show us how asset classes will perform each year, the best approach to managing the annual cliffhanger is to own everything all the time.

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[1]A portfolio strategy that involves setting target allocations for various asset classes, then rebalancing the portfolio to maintain these original allocations. (www.investopedia.com) [2]S&P National Municipal Bond Index [3]Dow Jones Equity All REIT Index [4]S&P 500 [5]MSCI Emerging Market Index [6]Russell 2000 Index [7]MSCI EAFE Index [8]YTD 2016 performance is based on closing prices from 12/22/16.