Smarter than picking stocks and timing markets. Keep your eyes on the prize.

- Asset allocation is the most important investment decision you make, so getting this right is the smartest thing you can do.
- Many investors want to "win" by picking better stocks and/or calling market turns, but this generally doesn't win. It usually subtracts value.
- There are tools for intelligent investing that develop smart asset allocation. The best tools manage risk in the Risk Zone.

Investors know that seeking alpha is not likely to succeed, but they enjoy the game, and want to be entertained. Behavioral Finance Professor Meir Statman (paraphrased)

A lot of time, energy and money are spent seeking alpha – trying to beat the markets – but there is a more productive way to focus your efforts. It may be less fun but it's much smarter.

What matters? What doesn't?

Sophisticated investors know what matters and what doesn't, but the behavior of many suggests otherwise. Asset allocation matters most. It explains 100% of investment performance – yes, all of it. Accordingly, most of your time, energy and money should be spent on asset allocation.

A plan for asset allocation is called an investment policy. Deviations from policy are intended to add value, namely alpha, but these attempts are well documented to actually subtract value.

The classic Determinants of Investment Performance is frequently cited for documenting that investment policy explains more than 95% of investment performance, but this study has been misinterpreted, and understates the importance of policy. An updated report entitled the Importance of Investment Policy corrects the analysis and finds that 100% of performance is explained by policy.

This updated report also documents that stock selection and market timing subtract value, but finds some evidence that concentration (big bets) can pay off. This finding was published long before the introduction of so-called "Active Share." In other words, big bets can pay off, but of course big bad bets generate big bad losses.

Let's focus on what works, and how to make the best decisions about asset allocation.

Smart asset allocation

Asset allocation is designed to achieve objectives with an acceptable likelihood. Allocations are adjusted in response to successes and failures in this achievement. Plus goals change through time. This financial navigation is dynamic and challenging.

Asset allocation decisions are risk decisions. You need to take a certain amount of investment risk in order to earn the return you need to achieve your objectives. Dr. Frank Sortino calls this target return the Minimal Acceptable Return (MAR). This risk decision is called "risk willingness" or "risk necessity." It should not be confused with market timing, another separate motivation for modifying risk. The risk willingness decision needs to be conditioned on three more decisions:

- Do you have the risk capacity for this level of risk?
- What is the smartest way to take this risk?
- How can you take this risk at the lowest cost?

There are circumstances when you simply should not take the risk it requires to achieve your objectives because you don't have the risk capacity. For example, there's a time in everyone's life when risk capacity is very low because the stakes are as high as they will ever be. You cannot afford to lose money at this critical juncture in your life, warranting its title as the "Risk Zone" that spans the 5-10 years before and after retirement.

Losses in the Risk Zone can devastate retirement lifestyle and reduce the length of time that savings last, even if markets subsequently recover. Sequence of Return Risk is the source of this Risk of Ruin. Even the wealthy should protect themselves in the Risk Zone because they too have plans that can be ruined. The rich can be devastated too as

they have more to lose. In the U.S. there are 75 million baby boomers in the Risk Zone, most of whom are taking way too much risk.

Smart asset allocation is tailored to achieve your goals, unless you cannot tolerate the required risk, especially in the Risk Zone. If you use an investment advisor, you are most likely invested in a in a model portfolio, but most models fail to recognize age and the Risk Zone, recklessly striving for an MAR. Fortunately, there are better models.

As for the second condition, the smartest way to take risk is to be as diversified as possible: global stocks and bonds, real estate, commodities, etc. Diversification provides the best returns for the risk over time. Offsetting this benefit, there is some evidence that big bets have paid off in the past, but these are typically unrepeatable. There's a saying that "Concentration can make you rich, but diversification keeps you rich." If you've lucked out and won a big bet, it's wise to protect your winnings.

And the third condition -- being cost conscience -- is simply common sense. Costs reduce returns. Interestingly, the desire to diversify and to keep costs low has recently driven investors to passive index investing, especially in Exchange-Traded Funds (ETFs). Investors are "getting it."

In summary, smart asset allocation integrates risk willingness with risk capacity, is broadly diversified, and low cost. The good news is that there are tools to be smart.

Why investors pursue what doesn't work

As Professor Meir Statman explains in his best selling book ***What Investors Really Want*** investors know that seeking alpha is not likely to succeed, but they enjoy the game, and want to be entertained. They want to win and to brag about it.

Similarly, famous author Jonathan Clements describes this behavioral incongruity in his recent Bullheaded article. Here are some excerpts:

> *If beating the market is a game that we're extraordinarily unlikely to win, why do so many folks keep trying? Market-beating efforts may backfire for most investors, but they remain a huge moneymaker for Wall Street. What else can explain the hysteria and silly*

> *arguments constantly emanating from investment "professionals"? These folks have all but given up*
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> *Investors' overconfidence is also fueled by a host of behavioral mistakes. We often imagine we see patterns in today's share price movements and believe those patterns foretell what's to come. Looking back, what occurred in the markets seems obvious—and we may even feel we predicted what happened, a mental mistake known as hindsight bias.*
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> *But perhaps the most insidious behavioral error is availability bias. Every year, most stocks underperform the stock market averages, because the averages are skewed higher by a minority of stocks with huge gains. Yet it's those big winners that stick in our minds, and they make beating the market seem easy. What if we try our hand at finding the next hot stocks? The odds suggest we'll end up picking duds instead—and our results will lag behind the market averages.*

Champions

Many smart people have advised against trying to pick better stocks and against trying to call market turns, including John Bogle, founder of Vanguard, and Nobel laureate Dr. William F. Sharpe, but few have said it as well as David Loeper, founder of Wealthcare Advisors, in this interview:

> *It is about avoiding needless sacrifice of your life. It is about unquestionable moral integrity. It is about using one's mind to create value. It is about the profound value of an individual's life and making the most of it. Our patented process applies these Objectivist premises, and this results in extraordinary value.*

The process Mr. Loeper refers to is described here as the roadmap to success. In a nutshell, it's a "Keep your eyes on the prize" process focused on establishing and achieving goals through the combination of intention and attention. Importantly, the process shuns costly distractions like stock picking and market timing.

How about the 60/40 stock/bond rule?

It used to be that 60% stocks and 40% bonds was the pat investment policy answer for everyone. This one-size-fits-all "solution" evolves from an estimate of market composition. The best diversification is achieved with market allocations. Despite what

we've learned in the past two decades, 60/40 remains the rule in Individual Retirement Accounts (IRAs), but this is a big mistake. According to EBRI (the Employee Benefit Research Institute), the average asset allocation in IRAs is 60/40 for all ages.

The success of TDFs has awakened investors to the fact that age matters, and that your risk capacity is at its lowest as you transition from working life to retirement, yet even TDFs are criticized for being one-size-fits-all. The ultimate in one-size-fits-all is "60/40 for everyone."

The moral is straightforward. Do not use the 60/40 rule, or any other pat allocation, in your IRA, or anywhere else, because getting asset allocation right is not that simple, and it's important to get it right. If your investment advisor tells you otherwise, you need a better advisor.

Anchoring

This article will not dissuade you from trying to pick securities and/or calling market turns, but it does provide guidance on establishing a starting point, an anchor from which you can deviate. Start with the best asset allocation for your needs and circumstances. Then from there you can concentrate in securities and asset classes you like or dislike. Without a starting point, it's hard to know what bets you're making. I hope you win.

Conclusion

The smartest investors spend their time, energy and money on what matters most, namely asset allocation / investment policy. Getting this critical decision right is not easy. Attempts to improve performance results beyond policy returns typically fail, undermining achievement of your goals. You can win the performance game but fail to achieve your goals.