NOTES: The Intelligent Asset Allocator by William Bernstein

Preface / Introduction:

- Your asset allocation policy is 10 times more important than stock picking and market timing combined in the long run and it is the only aspect of your portfolio you can directly control

Chapter 1: General Considerations:

- Look at annualized return – it will always be less than the average return and is better indicator
- Common Standard Deviations (SD – the 'swing', scatter, or tolerance of a number's target). This means that 66% of the time the number's actual value will be between 1 SD above or 1 SD below target:
  - Money Market (Cash): 2%-3%
  - Bonds: Short-term: 3%-5%
  - Bonds: Long-term: 6%-8%
  - Domestic Stocks: Conservative: 10%-14%
  - Domestic Stocks: Aggressive: 15%-25%
  - Foreign Stocks: 15%-25%
  - Emerging Markets Stocks: 25%-35%
- If you or your broker are not familiar with the SD of your investments… GET SOME LEARNING!

Chapter 2: Risk and Return:

- At least 20-30 years of data are needed to get a decent grasp on returns; good ideas can be had by monthly data for 5-10 years.
- Approximate *annualized* returns and SD's for major asset classes from 1926 to 1998:

Asset Class	Return	SD
30-day T-Bills:	3.77%	3.22%
5-Year Treasuries:	5.31%	5.71%
20-Year Treasuries:	5.34%	9.21%
Large Cap Stocks:	11.22%	20.26%
Small Cap Stocks:	12.18%	38.09%

- Nonsystematic Risk: the part of the risk that disappears with diversification
- Systematic Risk: the part of the risk that stays and cannot be diversified away
- Stocks are to be held for the long term – there are NO periods of return less than 8% for any 30-year period (data stopped at 2000)

Chapter 3: The Behavior of Multiple-Asset Portfolios

- Dividing your portfolio between assets with uncorrelated results increases return while decreasing risk – the lower the correlation the better (Excel has a CORREL function, too)
- Policy Asset Allocation – the 'rules' or 'template' you planned for your investments. This is the baseline you reference for all decision. E.g. is it 40% Bonds/60% stocks with Bonds and then how are those numbers broken up? What % to Large cap US stocks? Foreign? Etc.
- Rebalancing your portfolio increases long-term return while reducing risk – an unbalanced portfolio will eventually become an all-stock portfolio. Rebalancing means re-allocating your current balances to match your Policy Asset Allocation
- An all BOND portfolio is actually more risky (with less returns) than a portfolio that owns SOME stocks. Risk vs. reward must be planned out but all portfolios MUST own some stocks.
- Sticking to your Policy Asset Allocation through thick and thin is much more important that the "perfect" allocation

Chapter 4: The Behavior of Real-World Portfolios

- Bonds of maturities from 6 months to 5 years are good choices for portfolio risk-dilution
- The essence of effective portfolio construction is using large numbers of poorly correlated assets
- Foreign stocks belong in everyone's portfolio
- "Something everyone knows isn't worth knowing." –Bernard Baruch. Stay away from gimmicks and flavor of the year investing strategies
- No one knows where the efficient frontier is, but all seek it → lowest SD w/ greatest return

Chapter 5: Optimal Asset Allocations

- Distrust of market sentiment and "expert opinion" is a VERY useful tool.
- Asset allocation approach:
  - How many different asset classes do I want to own?
  - How "conventional" a portfolio do I want?
  - How much risk do I want to take?
- A level-one "vanilla" asset allocation:
  - US Large Stocks (S&P 500)
  - US Small Stocks (Russell 3000)
  - Foreign Stocks (EAFE)
  - US Short/Intermediate-term Bonds
- 3 Dimensions of Stock characterization: (1) nationality, (2) size, and (3) value vs. growth
- Consider a maximum of 75% Stock for the most aggressive investors and down to 25% for the least aggressive investors

Chapter 6: Market Efficiency

- Actively managed funds sow the seeds for their own destruction – avoid them (pg. 90)
- The January Effect (JE) no longer exists – the flavor is gone.
- "When an asset class does well, an index fund in that class does even better." –Steve Dunn
- Actively managed funds have a higher turn-over and capital gains – which are taxed
- A lot of actively managed funds tend to not beat the market… because THEY ARE THE MARKET
- Stocks should be bought like groceries, not perfume
- Stocks should be bought like gasoline, not like automobiles
- Don't rebalance too frequently: 1 per year in taxable and maybe even less in tax-sheltered
- Believe it or not, but momentum does exist for indexing – be aware

Chapter 7: Odds and Ends

- Dividend investing ideas – go with the 5 highest yielding on the Dow
- Good companies are generally bad stocks, and bad companies are generally good stocks
- During bull markets growth beats value, but during bear markets value stocks lose much less than growth stocks
- Any stock's returns can be divided into 4 categories:
  - Risk-Free Rate – the time-value of money (usually set at the short-term T-Bill rate)
  - Market-Risk Premium – additional risk by being exposed to the stock market
  - Size Premium – additional return earned by owning smaller cap stocks
  - Value Premium – additional return earned by owning value stocks
- Long-term equity returns are closely related to the dividend rate + the earnings growth rate

- Shlomo Benzarti and Richard Thaler calculated the risk horizon of the average investor is **1 year!**

Chapter 8: Implementing Your Asset Allocation Strategy

- Determine your basic allocation between stocks and bonds – based on loss tolerance:
    - Max stock allocation should be 10x the # of years until you need to spend the money
    - Tolerate 0% SD, go 10% stock; 10% SD:30% Stock; 20% SD:50% Stock; 35% SD:80% Stock
- Determine how much complexity you can tolerate, but you need at least 4 asset classes:
    - Easy: US Large Cap, US Small Cap, Foreign, US Short/Med-term Bonds
- Determine how much tracking you can tolerate
    - Go more US Large Cap stocks if you have to compare yourself to industry benchmarks – the other uncorrelated asset classes will not track as well
- Table 8-2 (pg 150): Stock Index Fund Summary – shows what's good for taxable vs. tax-sheltered
- When rebalancing:
    - Tax-Sheltered accounts: above or below average asset-class performance has a tendency to persist and it is best to let that run its course before rebalancing. If you rebalance every year or 2 you probably won't be too far off.
    - Taxable accounts: do so as sparingly as possible and some could argue never rebalancing because of the capital gains tax jolt you get each time
- A "healthy" commitment to Treasury Inflation-Protected Securities (TIPS) in your Tax-Sheltered account is a good idea
- Focus on the behavior of your PORTFOLIO not on the individual parts
- Economic and political considerations are worthless as market predictors
- Fund Expenses:
    - Bonds: <0.5%
    - US Stocks: <0.7%
    - Foreign Stocks: <1%