Asset Allocation

Adding Value in a Positive Sum Game

Nearly everyone has heard the investment advice: "diversify your portfolio." The concept of diversification has attached itself to the homely advice, "don't keep all your eggs in the same basket." The average understanding of this concept appears to be: invest in more than a few companies, for if any one of those investments goes poorly it's not financially significant.

While this understanding scratches the surface, the true meaning of the advice, when given properly, is nuanced. There's diversification within an asset class and the concept of what type of risk should be compensated with expected return. And then there's diversification amongst asset classes and the ability it gives to every investor to improve her return for the level of risk she's willing to take.

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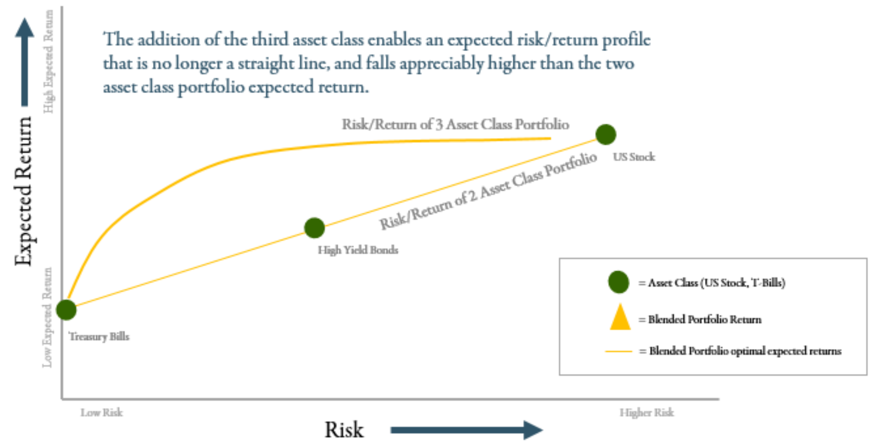
To operate with this broad view and to focus one's energies on combining asset classes thoughtfully is a way to improve investment outcomes at no expense to anyone else. It's simply organizing risk intelligently, such that the risks are often offsetting, resulting in a smoother path to a sought-after return.

One may own one asset class, for example, the U.S. stock market, and combine it with a risk-free U.S. Treasury bill. By controlling the percentage mix of these two assets classes, one may select along a straight line her expected risk and return profile.

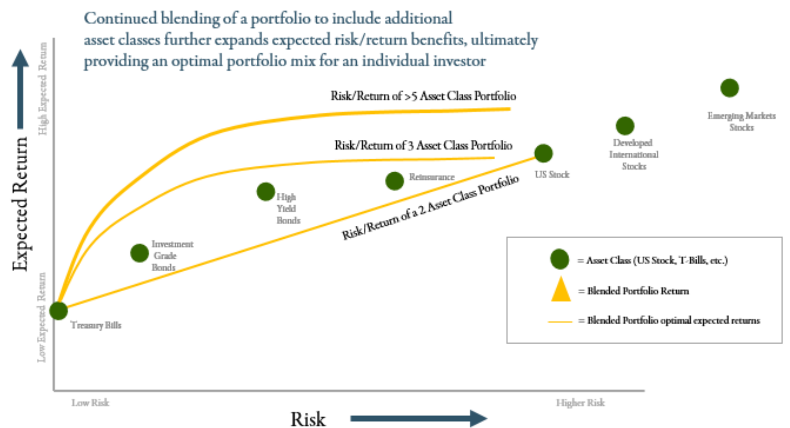
Source: Heritage Financial Services

However, if an investor expands the number of asset classes she's willing to participate in, something interesting happens to the feasible set of risk-and-return combinations available. The expected return exceeds any possible combination of two asset class returns, even though each of the individual asset classes underperforms the expected return of the combined portfolio.



Source: Heritage Financial Services

In finance, we use some advanced mathematics to solve for the maximum return achievable for any level of risk, and plot what's called the efficient frontier of portfolio options, as shown in the multi-asset class portfolios graphed here. The more unique asset classes in which one is able to participate, the better the optimal set of risk-return tradeoffs.



Source: Heritage Financial Services

Multi-asset class portfolios dominate all others, and clearly dominate the U.S. stock, Treasury bill portfolio. Better yet, the results don't count on someone else leaving money on the table—you don't need to outperform anyone else within an asset class to achieve a far superior experience.

But within any single asset class the opportunities to outperform others is significantly different. We discuss those differences in our paper on efficient markets, the second in our five part series on understanding investing.

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