

How to Build Your Portfolio to  
Maximize Returns and Minimize Risk

*"This is a  
GREAT book!"*  
John C. Bogle

The

# Intelligent Asset Allocator

William Bernstein

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# The Intelligent Asset Allocator

**How to Build Your Portfolio  
to Maximize Returns and Minimize Risk**

*William J. Bernstein*

**McGraw-Hill**

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# Preface

On July 31, 1993, I came across an article in *The Wall Street Journal* (“Your Money Matters” series) which examined the performance of various asset allocations for the period 1973–92. The article was based on research done at the T. Rowe Price mutual fund group. The technique used was quite simple: imaginary portfolios were constructed from various combinations of U.S. large and small stocks, foreign stocks, and U.S. bonds, and returns and risks were calculated. The article pointed out that over the 20-year period studied various fixed mixes of the above assets outperformed the single component parts (as well as most professional money managers), with significantly lower risk. I was intrigued. T. Rowe Price kindly sent me the data underlying their calculations, which I analyzed. The results were astonishing—almost any reasonably balanced fixed combination of the four assets outperformed most professional money managers over the same period.

For example, a “simpleton’s portfolio” consisting of one quarter each U.S. large stocks, U.S. small stocks, foreign stocks, and U.S. high-quality bonds had a higher return, with much lower risk, than large U.S. stocks alone (represented by the S&P 500 index). The S&P 500, in turn, performed better than 75% of professional money managers over the same period.

I was fascinated by the T. Rowe Price data; here was a simple tool for ascertaining historical asset allocation performance—collect data on the prior performance of various asset classes, and “backtest” returns and risks. To my disappointment, I could find no readily available software which accomplished this; I would have to write my own spreadsheet files. I began to buy, beg, steal or borrow data on a wide variety of assets over several different historical epochs and build portfolio models going back as far as 1926.

The calculations performed by T. Rowe Price and myself contained an important implicit assumption: that the portfolios were

“rebalanced” periodically. Rebalancing becomes necessary after a while because some assets in a portfolio will do better than others, and this will alter the original portfolio composition. In order to rebalance the portfolio back to its starting composition, some of the better performing assets must be sold—and the proceeds used to purchase more of the poorly performing assets.

Most experienced investors learn that the key to long-term success lies in a coherent strategy for allocation among broad categories of assets, principally foreign and domestic stocks and bonds. They also understand that market timing and stock or mutual fund picking are nearly impossible long term. They are at best a distraction. Put another way, it is far more important to come up with the right proportion of foreign stocks, U.S. stocks, foreign bonds, and U.S. bonds than it is to pick the “best” stocks or mutual funds or to “call” the tops or bottoms of the markets. (As we shall see later, nobody consistently calls the market, and almost nobody picks stocks or mutual funds with any persistent skill).

If you find this difficult to believe, consider the following: 1987 was not a great year for the U.S. stock market. U.S. large company stocks (represented by the S&P 500) gained only 5.23% that turbulent year, and small company stocks actually lost 9.3%. On the other hand, foreign stocks gained 24.93%. The clumsiest foreign fund manager would have beaten the most skillful small-stock picker that year. In 1992, the opposite would have occurred when U.S. small stocks gained 23.35% and foreign stocks lost 11.85%. Finally, the 1995–1998 period provided unprecedented returns for the biggest U.S. growth stocks but battered almost everything else.

Still not convinced? In the late 1980s, Gary Brinson, a noted money manager and financial analyst, and his colleagues published two sophisticated statistical studies of 82 large pension funds. They concluded that asset allocation accounted for over 90% of the return variability among the funds, with a less-than-10% contribution from market timing and actual stock and bond selection. *In other words, asset allocation policy was 10 times as important as stock picking and market timing combined.* In recent years many observers have suggested that the 90% figure is too high; perhaps asset allocation accounts for only 50% of return variability. Such arguments completely miss the point. Market timing and security selection are obviously important. The only problem is that nobody achieves

long-term success in the former, and almost nobody in the latter. *Asset allocation is the only factor affecting your investments that you can actually influence.*

It is thus truly astonishing that so much ink and airtime is wasted on analysts' predictions of the direction of stock or bond prices and on particular stock and mutual fund recommendations. In fact, when Mr. Brinson himself appeared on Louis Rukeyser's *Wall Street Week* in 1994 almost all of his comments were directed toward market timing and almost no attention paid to asset allocation strategy. The gambling instinct is ingrained in human nature, and few can resist speculation on events that cannot be foreseen.

So how do you arrive at the allocation that will provide the most return with the least amount of risk? You can't. But don't feel bad, because neither can anyone else. Not even Mr. Brinson, who until he retired had more assets under management than any other individual on the planet. Sure, you can look at historical data and examine *what has worked in the past*, but don't confuse that with *what will work in the future*. Later we shall look at historical data and attempt to extract from it useful portfolio advice, but the lessons are sparse. First, stocks are riskier than cash. Second, in the future they will probably have higher returns than cash, but not by as much as in the past, particularly the recent past. Third, portfolio diversification reduces risk. And last, index your investments wherever you can.

In fact, if you tire of reading this book and simply want a recipe for a serviceable portfolio, consider the following advice: Purchase the above-mentioned "simpleton's portfolio" consisting of index funds—one quarter each of U.S. large and small stocks, foreign stocks, and a short-term U.S. bond fund. Index funds have become almost as commoditized as computer chips and gasoline, and they are available through most large fund families and "supermarkets." I highly recommend Vanguard. At the end of each year, rebalance your accounts so that each of the four parts are again of equal size. That's it. Setting up the account should take about 15 minutes, and the annual rebalancing should also take about 15 minutes. You can forget about investing for the rest of the year. If the next 20 years are anything like the last 20, then you will outperform the portfolios of 75% of all professional money managers.

In 1996, I placed this book's first edition on-line and began writing regular pieces for my website, Efficient Frontier