Asset Allocation For Investors With an Appetite For Risk

A reader asks:

I recently started my first real job, and I am currently setting up my 401k. I am selecting my asset allocation. Using the website portfolio visualizer, I have been back testing different allocations. I came across an interesting portfolio that beats most of the allocations on the website (Sharpe ratio and CAGR). It's a 60 percent small-cap value and 40 percent large-cap value. I selected this allocation because I am willing to take the risk, and plan to change the allocation as I get older. My question is would you suggest this asset allocation to a younger person who understands the risk associated with the portfolio and has time on their side?

I realized early on in my investing career I wasn't well-suited to be a stock-picker. There's nothing wrong with picking stocks but it just doesn't fit my skillset or personality. So I've focused the majority of my time and energy on asset allocation throughout my career and believe that's where the majority of investors should spend their time as well.

With that in mind, here are some thoughts on this question from a number of different angles:

Optimize for behavior & needs, not formulas. Backtesting a strategy or allocation can be helpful when setting expectations and thinking through different scenarios but simply choosing the portfolio with the best looking risk-adjusted past returns can be dangerous. Even if it ends up being the best performing strategy going forward, your sense of time changes when running real money versus what you're looking at in a backtest.

Reset those expectations. Investors have been putting their money into the best performing strategies since the dawn of markets because it feels safer. Past is not prologue when it comes to Greek formulas, outperformance, and fund selection.

Being a contrarian can be a lonely endeavor. Value investing is a true contrarian approach -- just ask the millions of investors who worship at the altar of Warren Buffett. I'm only half kidding but investing in out of favor companies can be painful at times. This pain is likely one of the main reasons value has done so well in the past but a portfolio invested exclusively in value stocks requires a high level of patience and discipline.

Know what you're buying. There are a plethora of ways to calculate value when investing in factor-based strategies. "Value" is a pervasive term in the fund world but it pays to know the inherent bets your particular value approach is making before taking the plunge.

Naive diversification. A portfolio made up exclusively of value stocks, both large and small, could have hundreds of names across their respective mutual funds. But owning hundreds of companies doesn't necessarily make you diversified if all the stocks have similar characteristics. To outperform the market you have to be willing to be different than the market but you must understand that a concentrated factor portfolio introduces a healthy amount of avoidable risk if you don't understand market cycles.

Document your investment plan to account for potential changes. It certainly makes sense to change your asset allocation as you age and life events change your financial circumstances. But try to plot out those reasons in advance to avoid making a change for the wrong reason because of market or strategy duress.

The perfect allocation will only be known in hindsight. There is no perfect asset allocation, investment strategy, or position in the markets. A backtest in 10 years will be able to tell you what the perfect allocation would have looked like but there are no front tests that will tell you now. Whichever allocation you choose, at some point it will make you feel dumb.

Saving is more important than investing at a young age. It's good to see a young person thinking about their investments and showing interest in their future self by saving for retirement. But it's important to see the big picture when considering these topics when you're just starting out in the working world. Saving money on a regular basis to create good habits will create multiple times the amount of wealth for almost anyone compared to their investment selections.

Your portfolio matters but your personal finance decisions will almost always trump your investment decisions.

Further Reading:
10 Things You Can't Learn From a Backtest

Now here's what I've been reading lately:

- Asset allocation is meaningless is you don't define your investment goals (Monevator)
- "There are plenty of lessons to be learned from stock market bubbles, but the idea that they invalidate buy and hold is not one of them." (Irrelevant Investor)
- Jerry Seinfeld on tense times in comedy (NY Times)
- Estate planning isn't just for millionaires (A Teachable Moment)
- 5 questions about the stock market (Humble Dollar)
- The world's worst boss (Seth Godin)
- Why you should stick with buy and hold (Bloomberg)
- Why do so few people use 529 plans? (Belle Curve)