MARYLAND CAPITAL ADVISORS INC
WEALTH MANAGEMENT • RISK-BALANCED PORTFOLIOS

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Comment on "Smart asset allocation may be the only protection against chaotic times"
James K. Glassman, The Washington Post, March 5, 2011
(see http://wapo.st/hSC4eK)

Glassman's article contains elements that may sound familiar to clients of our Risk-Balanced Asset Allocation strategy. In particular, he advocates that investors should include the following elements in their portfolio:

Glassman's Recommended Portfolio Exposures
STOCKS
- Emerging Markets such as India, Brazil, China, etc.
- Small Company stocks
- Value stocks
BONDS
- "Laddered" Maturities out to 10 years with emphasis on "high-quality" corporate bonds
- TIPS (Treasury Inflation Protected Securities) for inflation-protection

Although we agree that the exposures Glassman highlights are important components of portfolio design, he misses some important aspects of proper, prudent portfolio management:

- ***Do not hold individual stocks.*** Glassman cites recent "...bolts from the blue..." such as the BP oil spill, yet, surprisingly, offers several individual stocks (ex. China Mobile, Tata Motors, etc) as attractive investments. *Our global stock market exposure is held in low-cost funds where single-company risk is diversified.*
- ***Do not rely on economic or industry forecasts when designing portfolio exposures.*** Glassman argues that 20-40% of the stock portion of a portfolio should consist of Emerging Markets shares. He justifies this exposure by stating that "...these economies are expected to grow at 6 to 8 percent a year – or three to four times the rate of U.S. growth." Such forecasts can vary significantly from reality and several academic studies have shown that GDP growth is a poor predictor of stock market returns[1]. More importantly, markets have already "priced-in" growth expectations – note that during the past 5 years Emerging Markets stocks have returned 4.2 *times* more than U.S. stocks[2]. *The portion of our stock market exposure held in Emerging Markets is more in-line with the portion of total global market value represented by such markets (currently about 13%).*
- ***Portfolio stock market exposures must be targeted and rebalanced periodically to manage risk and maximize return.*** The smartest element of asset allocation that Glassman failed to mention is the unemotional process of "selling high, buying low" that is at the core of a proper asset allocation strategy. *We diligently monitor portfolio exposures and periodically rebalance back to predetermined targets when market values rise or fall causing an over- or under- target exposure.*

[1] Jay Ritter [2005] "Economic Growth and equity returns", Pacific Basin Finance Journal. Also Dimson, Marsh, and Staunton [2002] Triumph of the Optimists, Princeton University Press
[2] 5-year returns: Vanguard MSCI Emerging Markets +59.0%, iShares S&P 500 Index Fund +14.0%

Glassman's comments on bond holdings are reasonable. We would add, however, that considerable attention must be paid to manage default-risk, interest-rate risk, and transactions costs when creating and managing a portfolio of individual bonds.

Two other statements from Glassman's article that we take issue with:

"Slowly and reluctantly, after three decades writing about finance, I have come to the conclusion that because the world has changed, investment strategy must change with it."
Asset Allocation has always been the right way to manage investment portfolio risk. His argument here suffers from a review of only recent tumultuous events. Significant market events have happened throughout the history of investing and one's inability to forecast them is the same now as it has always been.

In fact, Glassman co-authored "Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market" (published October 1, 1999). Investors may remember that the "Dow" index fell to a low of 7,286 (October 9, 2002) almost precisely two years following publication of this book. Over this period, the Dow Index generated a total return (including dividends) of -25.3% compared with +31.6% for the BarCap Aggregate Bond Index. As of this past Friday, the Dow Index closed at 12,170.

Clearly, Glassman's newly-found appreciation for asset allocation would have been a welcome strategy during the volatile 1999-2002 period as well as more recent periods since the publication of this book.

"Asset allocation is not the only way to hedge. You can own a "bear" mutual fund like ProFunds Short S&P 500, whose value moves inversely to the market…"
When you purchase an investment vehicle that moves in the opposite direction to an underlying basket of stocks, you are market-timing. Selecting the opportune time to hedge in this way is precisely as difficult as consistently selecting the proper time to purchase stocks. It does not work. *Asset allocation is a process of managing risk and return by reviewing what has happened rather than attempting to speculate what will happen – two very different approaches.*

All-in-all, Glassman's piece correctly emphasizes that portfolio allocation between stocks and bonds is the most important factor in determining portfolio performance. Strategies focused on selecting individual stocks or timing market entries and exits do not maximize long-term after-tax returns.

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