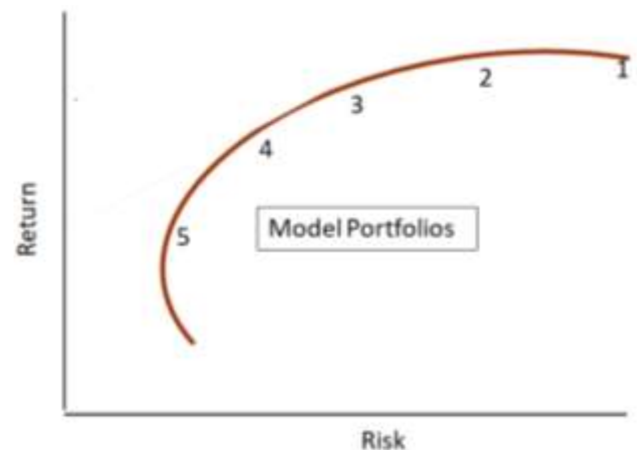
A Shout Out to Investors About Model Portfolios

- Most investment advisors use model portfolios to manage your assets, but they are oversimplified and inappropriate for many
- Models are very important because asset allocation explains 100% of investment performance.
- Risk has different meanings for different ages, so age should be integrated with risk in model portfolios.

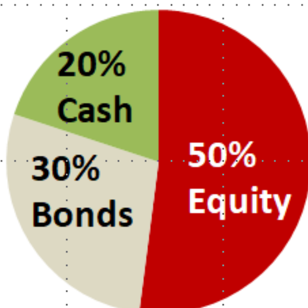
Most investment advisors use model portfolios provided by their firms or "turnkey asset management platforms" (TAMPs). These models employ Modern Portfolio Theory (MPT) to identify a family of portfolios along the efficient frontier, like the 5 portfolios shown on the right, ranging from high risk (1) to low (5). Modern Portfolio Theory is more than 60 years old.



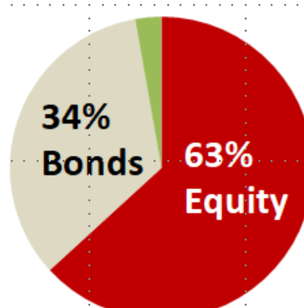
The models are frequently presented in pie charts like the following:

Traditional Model Portfolios

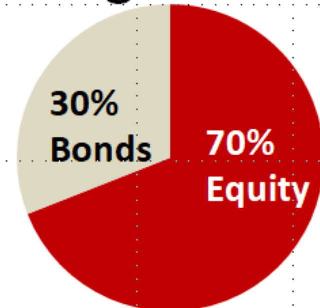
Low Risk



Middle Risk

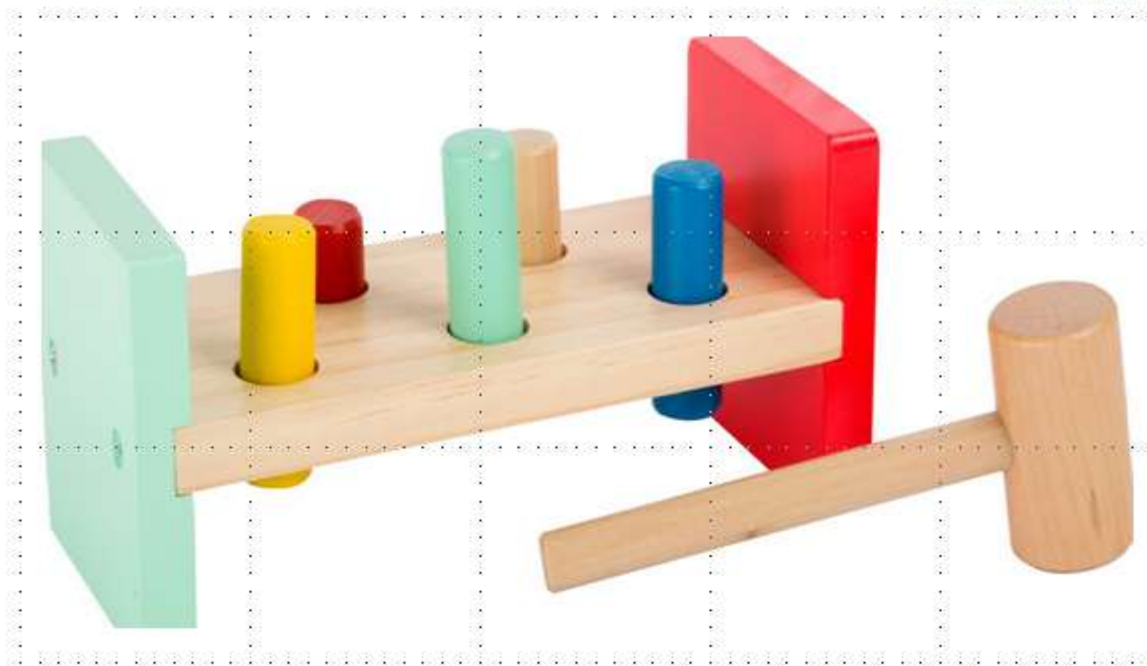


High Risk



The advisor's job is to determine your risk preference and map it into a model as shown on the right:

In simple terms, the advisor matches you up to one model out of his handful of models. This is oversimplified and inappropriate for reasons we describe in this article.



Everyone fits into a "personalized" peg hole

This well established approach is plain and simple. The problem is that it is too simple because it ignores a critical and obvious aspect of you, namely your age. As we explain in the following, risk has different meanings for different ages. Superior model portfolios integrate risk with age. If current portfolio models were cars they would be cruising without steering wheels.

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The importance of age

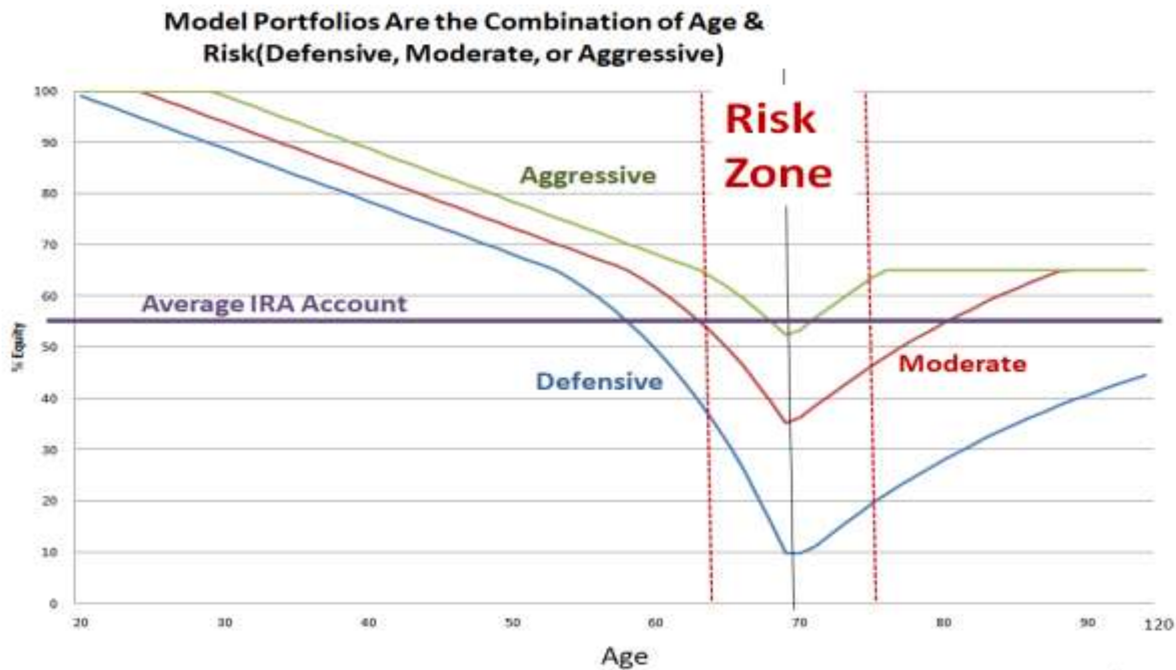
Your age is the best indicator of the time you have to invest, the most important factor in setting an investment strategy. Diversification is the only free lunch in investing, but

its benefits work best over many years. In addition to having enough time for diversification to work, your future earning power is always greatest when you're young, which means you can take bigger risks knowing you'll recover by the time you retire.

But as your working life comes to an end **Sequence of Return Risk** is a very real and serious threat, although most don't grasp its gravity. Your lifestyle can be ruined if you are unfortunate enough to experience losses during the transition from working life to retirement, even if markets subsequently recover. You only get to do this only once. It is the obligatory running of the gauntlet in lifetime investing. Here's an example:

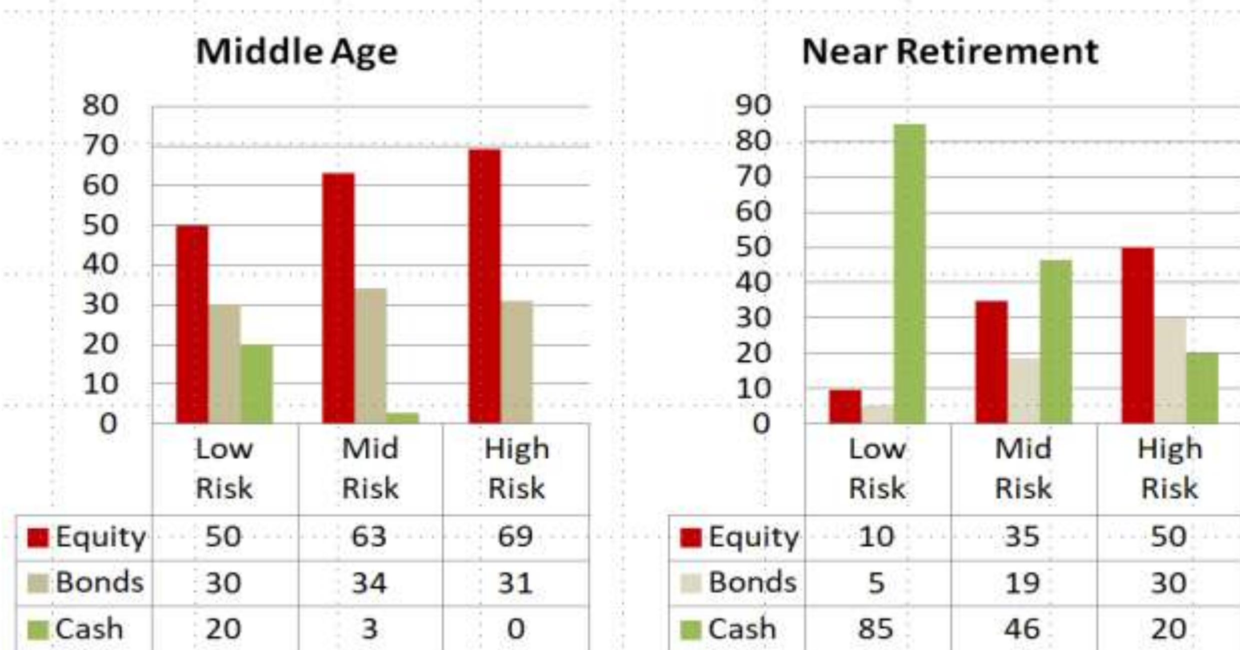
Superior models

We have seen an evolution in age-based modeling with the recent introduction of target date funds (TDFs) that have grown from nothing a few years ago to over $2 trillion today. The idea behind TDFs is good but the glide paths of most TDFs are too risky for those near retirement, so our superior models correct this mistake. Sequence of return risk is managed with a V-shaped glide path that is very defensive in the Risk Zone that spans the 5 years before and after retirement. As you can see in the following graph, age is integrated with risk to create a very fluid family of thousands of models.



An Example

The following graph compares the models for a middle aged person to models for someone near retirement. As you can see, you are moved to safety when you are in the Risk Zone, nearing retirement. The most aggressive model for someone near retirement is similar to the safest model for a middle aged person.



Middle Age

	Low Risk	Mid Risk	High Risk
Equity	50	63	69
Bonds	30	34	31
Cash	20	3	0

Near Retirement

	Low Risk	Mid Risk	High Risk
Equity	10	35	50
Bonds	5	19	30
Cash	85	46	20

Conclusion

Most of our nation's 75 million baby boomers are in the Risk Zone, and most are in models that ignore the Risk Zone, taking substantial risk. Even worse, many are in the old "60/40 stock/bond for everyone" solution according to EBRI. You deserve safer models.

Models are very important because asset allocation explains about 100% of investment performance – yes, all of it. The widely held belief that investment policy explains 95% of investment performance is debunked in this article. The more accurate percentage is 100%. And the other revelation in the article will come as total heresy to those who are seeking alpha: Stock selection and market timing generally detract from investment performance.