



**American Trust
Investment Advisors**

PERSPECTIVES

Fundamental Forces

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Physics class was not a forte for at least one writer of this newsletter. To protect his reputation, we'll leave his identity a mystery... just like so much of physics itself. We were thinking about the mysteries of physics because we recently read that Albert Einstein is reputed to have said that compound interest is the eighth natural wonder of the world and the most powerful thing he had ever encountered. More powerful than the energy released from splitting the atom?! Now that is a statement. That puts the power of compounding right up with the fundamental forces of the universe. And what in turn drives compounding of interest, or investment results for that matter? Nothing so much as *asset allocation* – the mix of stocks, bonds and cash in your investment portfolio.

It pains us to say that asset allocation is so important to long term investment returns because, as stockpickers, we like to think that picking the right stocks is the most important driver. And we spend much of our time tracking, investigating and valuing individual stocks to enhance your portfolio's performance. But study after study has underscored that, for the vast majority of investors, getting asset allocation "right" is the most important determinant of long term performance. So it clearly merits our attention, and yours.

But what is the "right" asset allocation? This question is far more easily posed than answered, primarily because the right answer will be highly personal.

There is an old rule of thumb that we have heard suggesting that the proportion of stocks in one's portfolio should be the inverse of one's age. For clarity, the idea is that a 20 year old should have 80% of his or her portfolio in stocks, a 30 year old should have 70% in stocks, etc., and at age 90 one should have just 10% in stocks. There are exactly two things that we like about this framework: (1) it implies we should start investing at age 20; and (2) it implies that we will all live to be 90 or more. Seriously, and in fairness to the authors of this old adage, the notion that as we get older we should take less risk, and therefore decrease our allocation to stocks, is generally sound advice. But this "inverse of your age" formula is far too simplistic because it is insufficiently personal.

Proper asset allocation will be dependent on your overall financial situation, and on your preferences. By overall financial situation, we mean on the one hand that you should factor in such considerations as current and projected income, owned businesses, real estate holdings, pensions, spousal income or benefits, insurance policies, potential inheritance and other investment assets. On the other hand, you should also consider your needs for: on-going income; one-time outlays for tuition, real estate, assistance to relatives; and charitable giving plans. Personal preferences might include risk tolerance or some specific investment goals to attain. If all of this sounds rather involved, that is because it is. We cannot condense all of the various factors that you should consider onto a page only because your own situation is uniquely your own.

What we **can do** is to give you the benefit of history with respect to various asset allocation strategies, and to help you think through some scenarios and possible outcomes using history as a guide. Attached as a third page to this investment newsletter is a graphical representation of investment returns over the last 60 years for various blends of stocks, bonds and cash. These use the S&P 500's performance for stocks, and similar benchmark indices for bonds and cash, and were computed by Ned Davis Research. The middle section of the page is a bar graph showing the average returns (in green), the worst one year loss (in red) and the best one year gain (in blue) for each asset allocation strategy. Let us hasten to warn you that past returns are no guarantee of future returns, and that any investment in stocks or bonds involves the possibility of loss of capital.

Notwithstanding these warnings, we still believe that the past offers some interesting insights: 1) As you might expect, a higher proportion of stocks in one's portfolio has historically led to higher average returns. This is true for each of the steps from 0% stocks toward 90%; 2) Somewhat unexpectedly, the maximum one year loss is minimized at a 20% stock allocation rather than at 0% stocks. This is a healthy reminder that bonds also carry risk, and a small stock allocation may actually reduce the risk in a portfolio; and 3) as enticing as higher average returns may be, investors need to carefully consider their willingness to sustain losses. A 34% loss in one's portfolio, shown as the worst one-year outcome for the 90% stock mix, can be an irrecoverable loss if one's time horizon is short.

And now we would like to return to Albert Einstein's observation about the power of compounding. The right hand side of the table (computed by us) shows the future value of a \$100 initial investment, compounded at the average historical return for each portfolio mix, after three different time intervals – 10 years, 20 years and 30 years. While the difference between a 6.2% return (0% stocks) and an 11.6% return (90% stocks) doesn't sound all that large, when compounded over one, two or three decades the differences become staggering. But be very careful in what you take away from this analysis. There is a very real risk that historical returns will not be equaled in the future. Secondly, for many investors, putting assets at risk through larger equity allocations may very well not make sense. This could be because they have sufficient financial resources already and therefore the potential for growth is less relevant to them. For older individuals, for whom a 10 year investment horizon might be more appropriate, the differences may not be as meaningful as the potential risk. For many investors however, a healthy exposure to stocks may lead to much more significant growth over the long term.

What we **can also do** to help you with asset allocation is to suggest that we speak about these matters in the coming months. The stock market has made a dramatic recovery from its lows, and we are still finding stocks that we find to be attractive. But asset allocation is primarily about you and your situation. What is your risk tolerance? Appetite for growth? What has changed recently? It is worth revisiting these issues as they are such fundamental forces behind the long term health of your portfolio. And as at least one of us learned in physics class, fundamental forces are what create momentum, which applies as much to investment portfolios as it does to physical objects. We look forward to speaking with you soon.

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ASSET ALLOCATION - Risk & Reward

One Year Total Returns

(Based on S&P 500, Barclays CapitalLong-Term Treasury Index* & T-Bill 12/31/1950 - 12/31/2009)



A LOOK AT THE LAST 60 YEARS

LOOKING FORWARD

(Based on prior 60 year returns)

Top bar - average return
 Middle bar - Largest one year gain
 Lower bar - largest one year loss

Value of \$100 given average return
 10 years 20 years 30 years

<u>Portfolio Mix</u>			<u>2009 Return</u>						
<u>Stocks</u>	<u>Bonds</u>	<u>Cash</u>					<u>10 years</u>	<u>20 years</u>	<u>30 years</u>
90%	0%	10%	24.0%	-33.9%	11.6%	46.2%	\$317	\$1,006	\$3,192
80%	10%	10%	19.4%	-29.3%	10.8%	41.1%	\$293	\$859	\$2,517
70%	20%	10%	15.0%	-24.3%	10.1%	36.3%	\$273	\$747	\$2,044
60%	30%	10%	10.7%	-19.0%	9.4%	31.9%	\$255	\$651	\$1,659
50%	40%	10%	6.6%	-13.4%	8.7%	31.2%	\$238	\$566	\$1,347
40%	50%	10%	2.7%	-8.7%	8.2%	30.5%	\$226	\$513	\$1,161
30%	60%	10%	-1.1%	-5.4%	7.6%	32.1%	\$213	\$455	\$971
20%	70%	10%	-4.8%	-4.8%	7.1%	34.2%	\$203	\$412	\$836
10%	80%	10%	-8.3%	-8.3%	6.6%	36.2%	\$193	\$373	\$720
0%	90%	10%	-11.7%	-11.7%	6.2%	38.4%	\$186	\$344	\$639

Maximum one year loss increases when stock allocation is a small percentage of the portfolio

* Ibbotson Long-Term Treasury Index before 1973

Past investment performance is no guarantee of future investment performance.

Source: Ned Davis Research, Inc., American Trust Investment Advisors