



Asset Allocation for Individuals

Why it is different for owners of money

Any meaningful discussion about investing starts with an indisputable truth: by distributing a portfolio's value across multiple asset classes, an investor is able to improve the relationship between expected return and risk. That's asset allocation.

Asset allocation – built on the work of Harry Markowitz and other pioneers at the University of Chicago's veritable Nobel Prize factory – is really the crux of present day investing. Empirical study proves its importance: the most significant determining factor in investment results is not the selection of individual securities within an asset class, but the weighting of allocations among diverse classes (such as US equities, bonds, international stocks and others).

Puzzling outcomes

Everyone agrees that asset allocation is critical, and that allocations should reflect the needs, goals and preferences of the portfolio's owner. Still, the process of actually doing it is often surprisingly unscientific and potentially counter to individual investor needs.

During my career in the private wealth departments of large investment banks, I was often puzzled by the asset allocation process. Wealth management clients represented a truly diverse spectrum of young and old, working and retired, frugal and spendthrift. Some needed considerable income. Some needed none. Despite the many differences, the recommended asset allocations generally came out more or less the same. Furthermore, the allocations for individuals often looked very much like those for institutional clients, such as pension funds, endowments or foundations. This sausage factory approach, where any and all inputs resulted in the same output, seemed misapplied, to the detriment of all.

Seeing differences

These seemingly generic asset allocations ignore two important facts – individuals pay taxes and individuals are unique.

Because pension funds, endowments, and foundations do not pay taxes on investment income, their asset allocations can completely ignore the tax consequences of capital gains and dividends. Individual investors have no such



luxury. While some individual income may be tax-deferred, little if any is completely tax-free. Therefore, tax-efficiency should be factored into every allocation choice. Utilizing institutional models for individuals ensures a non-optimal outcome.

The second idea, that individuals are unique, seems self-evident. Still, the differences are not always reflected in allocation percentages. Allocations that are ideal for a risk-averse retired family patriarch cannot also be ideal for a young, risk-ready entrepreneur with no family; they must reflect the fundamental characteristics of the unique investor or family. Appropriate allocations should not only help the investor meet financial goals, but should also help them sleep at night. This is only possible when choices are made in light of individual characteristics.

Build from the bottom up

At OCM, we believe in a rigorous, repeatable and understandable process of asset allocation that starts with the individual and builds upward. We do not believe there is one “best” set of allocations for all investors, only allocations that are best for each individual. We see the effort as both art and science, where the art is gaining a deep understanding of the individual and the science is identifying the appropriate asset classes and allocations to suit that individual.

We make no allocation recommendations until we understand six key aspects of the investor: personal and financial goals; income needs; tolerance for volatility/risk; emotional investment stamina; tax status; and timeframe. A candid discussion of these personal factors creates the foundation on which all investment decisions are made.

Our specific asset allocation selections are based only on market information from primary, objective sources, such as the Federal Reserve, or Bloomberg Market Data. We seek insight from information, unfiltered by self-interested parties. The process is transparent, repeatable, objective and fitted to the individual’s needs.

Once allocations have been set, we take a world “CAFÉ” approach - seeking optimal investment vehicles among Cash, Alternative investments, Fixed income, and Equities. Under these four broad allocation categories, OCM is free to select any tax-efficient investment from virtually any provider of investment products. We can and do look domestically, internationally, by quality, by sector, by capitalization, by currency, and so on. Our only motivation is to identify and purchase high quality, tax-efficient securities while minimizing transaction costs and other drains on performance.



Catching the changes

The final element in asset allocation is a systematic feedback loop that triggers a reevaluation of allocations when changes arise. These may be changes in personal, business or familial circumstances, or changes in market conditions. We rely on frequent communication with clients to ensure that all significant personal developments are built into allocations.

Owners versus agents

Returning to the issue of individual versus institutional portfolios, tax issues are not the only disparities. It is helpful to realize the fundamental differences between the holders of these assets.

An individual, as the actual owner of the assets, invests for the interests of his or her family. The manager of an institutional account, on the other hand, does not own the assets. He or she acts as an agent, administering the funds on behalf of others – whether they are alumni, pension holders or charitable contributors.

As agents, institutional portfolio managers have vastly different investment goals and parameters than individual owners of assets. These differences necessitate very different asset allocations. Consider the chart below:

The OCM Difference
OCM invests only family wealth. We have no institutional clients. All asset allocation discussions and decisions are based solely on personal parameters. Tax-efficiency is built in, not added as an afterthought to institutionally-derived allocations. We have complete and open access to preferred products at preferred pricing, regardless of origin, with no incentive to direct assets to any specific provider.

	Owners	Agents
Performance measure	Absolute performance	Relative performance
Goal	Capital preservation	Growth
Timeframe	Multigenerational	Actuarial, quarterly
Taxation	Taxable	Non-taxable
Risk	Must sleep at night	Must protect job

For further reading: “Unconventional Success, A Fundamental Approach to Personal Investing” by David F. Swensen; “The Art of Asset Allocation” by David M. Darst; and www.ibbotson.com.

John Osbon
August 2006

© 2006 Osbon Capital Management