



INVESTMENT ADVISORS, LLC

Book Review

Asset Allocation, by Roger C. Gibson, CFA, CFP

In 1952 Harry Markowitz published an article in the Journal of Finance entitled "Portfolio Selection." In this article he developed the first mathematical model that specified the volatility reduction that occurs in a portfolio as a result of combining investments with different patterns of return. The amazing thing about this, Gibson points out, is that his thesis was developed long before the advent of the modern computer. Prior to this, the term asset allocation did not exist. Markowitz's influence on the world of modern finance has been so profound that he became the father of Modern Portfolio Theory and won the 1990 Nobel Prize in Economics.

Prior to this time, investment management focused primarily on security selection and the relationship between individual stocks or bonds with respect to volatility. Because the majority of capital markets globally were comprised primarily of U.S. stocks and bonds, there was little attention paid to international investing. As Markowitz's work became widely recognized and accepted in academic circles, the focus with respect to investment management shifted from individual security selection to the relationships between investments and their impact on the portfolio as a whole.

Because the vast majority of daily transactions are performed by large institutions and with the free flow of information made available by advances in technology, Gibson points out that financial markets have become very efficient. To demonstrate this point he discusses the study of ninety-one large pension plans. The study sought to determine how investment returns are determined by three factors: asset allocation, market timing, and security selection. The outcome was that asset allocation determined 91.5% of overall portfolio performance! Only 4.6% of the total return was determined by security selection, 1.8% from market timing, and 2.1% from a combination of other factors.

In an efficient market the prices of securities are always fair. Therefore, there is no additional reward for investing in any one individual security over a broadly diversified portfolio of securities within the same asset class. An efficient market assumes a rational investor considers the fact that there is no additional return for investing in individual securities, only additional risk.

In Gibson's view, the investment management profession is being transformed from focusing on security selection and market timing, to determining appropriate investment policy with respect to an investor's long term goals and objectives. The goal is no longer to beat the market through market timing and security selection, but rather to devise long-term strategies that will move investors to their financial goals with the least amount of risk.

The role of the financial advisor, according to Gibson, is to implement an asset allocation policy and adhere to that policy with patience and discipline according to the goals and objectives of the individual investor.

About the Author

Roger Gibson is internationally acknowledged as an expert in investment policy and portfolio design. Gibson is a frequent speaker at national conferences sponsored by such organizations as the Securities Industry Institute, the American Institute of Certified Public Accountants and the International Association for Financial Planning. Gibson serves on the Editorial Advisory Board of the Journal of Financial Planning and is often quoted in financial publications including The Wall Street Journal, Forbes, Money, Fortune, The New York Times and U.S. News and World Report.