

## "Our Formula for Functional Asset Allocation"

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Over the past year, we have revised and updated our asset allocation model to incorporate the Cambridge concept of the Financial Life Cycle. We are implementing the changes through our revision of the Cambridge Model Portfolios. We are calling this approach "Functional Asset Allocation."

This concept builds on the basic Cambridge Pyramid. We use this pyramid model to display client financial information, rather than the traditional accountant format with long rows of numbers. We find this helps clients "visualize" their assets, and best understand the financial strategies we recommend.

I developed the Cambridge Pyramid about 20 years ago by analyzing the net worth composition of my most "successful" clients to determine how their assets were allocated. I used three basic asset categories:

- Interest Earning (cash/bonds)
- Real Estate (personal residence/rentals/land)
- Equities (domestic/foreign/employer stock)

At a conference on asset allocation earlier this year, I discovered this same basic approach was originally proposed in the Talmud over 3,000 years ago: "Invest one third in land, one third in business and one third in reserves." We're not talking mere financial theory here; this is a biblical imperative!

While it appears that a rough allocation of one third in each category seems about the right average over a lifetime, we recognize that different stages in life require somewhat different mixes.

Modern Portfolio Theory, on which most asset allocation theories are based, focuses on diversification across asset classes to reduce the risk of a portfolio. Usually asset managers identify six to twelve different asset classes, and then use computer models to ascertain the "efficient frontier" - presumably the exact mix of investments in each asset class which has historically provided the highest return for a given amount of risk. While this approach is very suitable for managing large pension funds, most people don't have enough zeros in their portfolio for this approach to work very well.

Our approach is called "Functional Asset Allocation" because, when working with families and individuals, each category serves an important function, or purpose, beyond simple diversification. For example, while Real Estate is recognized as a separate asset class by most money managers, I believe the value of your personal residence is more than a straight financial calculation. A great deal of your home's value is in your own enjoyment. Likewise, Functional Asset Allocation takes into account the reality that taxes are a driving force in Middle America.

While Modern Portfolio Theory seeks to optimize statistical returns on a passive, static investment portfolio relative to risk based on historical performance, Functional Asset Allocation uses a different paradigm. It is based on optimizing value in the utilization of assets in a household, and on the psychological needs and life goals of real people in a dynamic society.

Interestingly, our experience and comparative analysis have found that Functional Asset Allocation not only provides most of the benefits of diversification of Modern Portfolio Theory, but also yields a better after-tax return with less risk for Middle America.

Using Functional Asset Allocation, a client's assets are distributed across three asset categories to accomplish specific purposes:

1. Interest Earning consists of two broad asset classes (Cash and Bonds) and serves the purpose of Capital Preservation. We want to make sure that clients have adequate cash flow, regardless of what happens in the financial markets - and in their lives - in order to maintain their standard of living for a given period of time. In the early stages of the Financial Life Cycle, we have clients accumulate enough in this asset category to provide six to twelve months of liquidity, before making long term investments. In later stages of life, our formulas are structured to provide a sure cash flow for ten, twelve or even fifteen years. The appropriate attention to Capital Preservation in each stage gives clients peace of mind when they follow Cambridge Model Portfolios. To assure maximum tax efficiency, we recommend using primarily retirement assets to fund this category, except for the amount needed for day-to-day liquidity.

2. Real Estate is divided into three asset classes: Personal Residence, Productive (including REITs and rental property) and Non-Productive (such as vacant land, second homes and passive limited partnerships). The unique functions of real estate include personal use and enjoyment (as discussed previously), and the opportunity to leverage by mortgaging the property. Positive financial leverage through a home mortgage provides Americans with the most advantageous after-tax investment vehicle in the world (particularly with the changes in the new tax bill). This is why we place so much emphasis on this asset category relative to what most investment managers recommend.

3. Equities includes four asset classes: Domestic mutual funds, International funds and Gold bullion (which hedge the dollar), Individual Stock holdings (segregated because of the higher volatility with little diversification) and Stock/Options from an employer (which carry a clear market advantage). Equities are the growth engine, but subject to the most volatility. Most standard asset allocation approaches ignore the reality that company stock plans are the driving force (requiring careful tax management) in the portfolios of many employees, and that "recreational investments" in stocks carry a different risk component because there is not usually enough money to adequately diversify. We try to concentrate non-pension assets in index funds to take advantage of the favorable capital gains rate, and concentrate pension funds in the area where active money management has shown the best result: small cap and emerging market funds.

As a living theory, we make periodic changes to the Cambridge Pyramid to reflect changes in new investment vehicles, tax laws, etc. - another reason we say "The Cambridge System is a process, not an event!"

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