Pie-Eyed Over Pie Charts

By Roger Balser
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If you've ever worked with a stockbroker or financial planner, you've most likely been subject to a barrage of fancy-looking pie charts. Asset allocation models have been displayed in this graphic format since the pie was first invented, it seems.

Pie charts are standard tools that one views when meeting with a stockbroker or financial planner. I like to call these folks "pie-charters" because their recommendations are usually all the same. It doesn't matter which firm you're working with, when you're meeting with your financial planner or stockbroker they always recommend a blend of growth vs. safety investments and fixed income vs. stocks. Traditionally they'll recommend a 60 percent growth and 40 percent safety split. Now yours may be a 70–30 percent split, or an 80–20 percent or even a 50–50 percent split, depending on your age and/or risk tolerance; but mostly they recommend a 60–40 percent split.

In a traditional 60–40 pie chart portfolio, 60 percent is directed to growth investments and the other 40 percent to fixed income or other types of "safe" investments.

On the growth side of a normal pie chart allocation, the largest piece you'll find is invested in large-cap growth stocks or mutual funds. Financial folks generally put a smaller percentage in things like mid-cap stocks or mutual funds, and then a smaller amount in small-cap stocks.

Finally the smallest slice is directed to international equities or emerging markets. Sometimes commodities or gold would also be recommended, but not too often.

The "Safe" Side

The other side, or the "safe" side, is allocated to fixed income or bonds. Professionals will often stagger the bond portfolio between short-, medium- and long-term bonds. The rest will be in cash or a money market account.

So what could possibly be wrong with this conventional type of pie-chart portfolio?

Well, there are a lot of issues with this type of portfolio in my humble yet wise opinion. So let's try and tackle a few of them.

First, for the past 15 years small-cap investments in general have been the best performers. On the flip side (because they've been the best performers), you've seen large-caps really lag. In fact, there was a period from 2000 to 2010 where the Standard and Poor's 500 — the large-cap stocks — returned nothing.

If you were a large-cap, pie chart type of investor, your large-cap growth portfolio really didn't do so well. And that was probably the bulk of your portfolio.

So on the growth side, as a pie chart investor you have some real issues to deal with. (This is living proof that investing is just not plug-and-play!)

Looking at the fixed income, or "safe" side, bonds are riskier than they've been in the last 30 years. Since the late 1980s bonds have been a terrific investment vehicle. You earn your income and you usually had a little capital appreciation. This is because as interest rates go down bond prices go up. Now that interest rates are near zero, you're probably looking at the reverse.

Real Losses

So individuals who own bonds are realizing significant capital depreciation in their accounts. Real losses. Having 20, 30 or 40 percent of your portfolio in fixed income or "safe" investments can do real damage to your future.

Turning our sights to the 2008 meltdown, the worst market most of us have witnessed, the 60–40 portfolio that was supposed to protect you actually returned a net loss of 41 percent. Then it took four years to get back to even.

Finally, the other problem is if you're in your 50s and you take this pie-chart approach. Keep in mind that you'll most likely need this money in 15–20 years, so you'll really need to step on the gas. This is the time you should be trying to make as much money as you can.

But isn't that risky?

There is risk everywhere. There is risk now in "safe" bonds. And there is always risk in stocks.

As an investor you need to know that having a big chunk of your assets in "safe" fixed income areas does not necessarily make a ton of sense today.

Fitting Into the Pie Chart

The whole plug-and-play idea of fitting you into a pie chart scenario that's based on a standard risk questionnaire is not the best approach in today's market.

So why do stockbrokers and financial planners keep using the pie-chart method if it has flaws?

Well, because most stockbrokers and financial planners only have one playbook. They only know buy and hold. Then they re-allocate on a specific date usually three or six months down the road. They can't tell you what asset classes or sectors are doing well because, well, they just don't know.

It is easier for them to just suggest sprinkling a little bit of your money into everything. Let's spread it around. That's akin to saying that if you buy enough lottery tickets you might hit a jackpot at some point.

So to avoid eating humble pie, investors need to know which asset classes and sectors are working well. That's why the use of point and figure charts and relative strength gives you a distinct edge. Those charts clearly indicate which asset classes and sectors are favorable and unfavorable, and will improve your performance over the long haul.

MANA welcomes your comments on this article. Write to us at mana@manaonline.org.

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