Equally weighted asset allocation strategy

An equal-weighted strategy is a practical benchmark, assuming it's designed properly. "The key is including enough asset classes to avoid the risks that can be eliminated through diversification."

History's first asset allocation strategy

The idea of spreading wealth evenly goes back to the Babylonian Talmud, an ancient Jewish text, which recommends holding equal amounts of property, business and what now's referred to as liquid assets.

"As it turns out, the Talmudic wise people knew what they were talking about," according to an analysis in the winter 2009 issue of The Journal of Portfolio Management. Another research paper published that year in The Review of Financial Studies reported that **equally weighting a U.S. stock portfolio was** competitive if not **superior against more than a dozen other "smart" models**.

No wonder equally weighted ETFs have fared well relative to their conventionally allocated counterparts in recent years. Consider the **Guggenheim Standard & Poor's 500 Equal Weight ETF (RSP)** and the SPDR S&P 500 (SPY). Each holds the same 500 U.S. companies and tracks the same stock market index. But the equal-weighted fund beat its market-capitalization-weighted counterpart by a comfortable margin over the past three years through June 15, 2012: **17.4 percent per year vs. 15.3 percent, respectively, according to Morningstar.**

Equally weighting asset classes has an encouraging record, too. Consider a portfolio that initially holds identical amounts of the 10 asset classes listed in the nearby table. **This passive strategy earned 8.8 percent a year for the decade through the end of 2011, based on an equal mix of the 10 indexes. That compares with just 2.9 percent for the U.S. stock market as measured by the Standard & Poor's 500 index.** (Of course, in reality you can't invest directly in an index, but rather a fund that replicates an index, and returns will be reduced by fund costs. But this serves as an example.)

Even more telling: the equal-weighted strategy for those 10 asset classes beat 90 percent of 1,200-plus professionally managed asset allocation mutual funds with histories of at least 10 years over that period, according to analysis of Morningstar data. (2001-2011)

Major Asset Classes

Asset allocation helps reduce risk. When **equally weighted in a portfolio**, the indexes listed below produced a **superior return with less risk**. To assemble such a portfolio, an investor would choose one ETF from each asset class and give it a 10 percent weighting. Past performance is no guarantee of future results.

Asset class	Index	Tickers of representative ETFs
	Stocks	
U.S. stocks	Russell 3000	VTI, IWV, SCHB
Foreign developed-market stocks	MSCI EAFE	VEA, EFA
Emerging-market stocks	MSCI EM	VWO, EEM
	Bonds	
U.S. bonds	Barclays US Aggregate Bond	BND, AGG
Inflation-indexed Treasuries	Barclays Treasury TIPS	TIP, IPE
Foreign developed-market bonds	Citigroup WGBI ex-US	BWX, IGOV
Emerging-market bonds	Citigroup ESBI-C	EMLC, EMB, PCY
High-yield bonds	iBoxx High Yield	HYG, JNK
	Commodities	
Commodities	DJ-UBS Commodity	GSG, DJP, RJI
	Real Estate	
Real estate investment trusts	MSCI REIT	VNQ, RWR

Risk management makes the difference

What is equal weighting's secret?

Rebalancing.

Rebalance every 12 month/6 months or 3 months depending on how strongly the different assets changed over time. (maintaining equal weights by imposing the **discipline of buying low and selling high** gives you superior results in the long-term).

Maintaining equal weights requires periodic selling and buying to keep market fluctuations from pushing a portfolio to extremes. Rebalancing can be dangerous for a limited pool of securities or asset classes. But casting a wide net keeps a lid on risk by imposing the discipline of buying low and selling high. The equal-weighted strategy using the asset classes in the table, for instance, was rebalanced at the end of each calendar year.

If you own a broad array of assets and refrain from extreme bets, history suggests that the winners will have a modest edge in the long run. There'll be losers, of course, particularly in the short run. But asset classes don't go out of business. Meanwhile, the global economy's bias for growth will help smooth over any rough edges in the long run.

Performance of Risk-Based Portfolios from 1968 to 2011

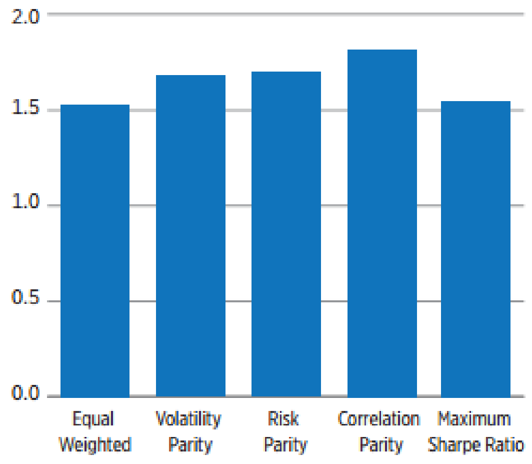
	Market (Value-Weighted)	Equal Weighted	Risk Parity	Maximum Diversification	Minimum Variance
Average Excess Return	5.1%	7.2%	7.2%	5.5%	5.7%
Standard Deviation	15.6%	17.9%	16.7%	19.1%	12.5%
Sharpe Ratio	0.33	0.40	0.43	0.29	0.46
Compound Return	4.1%	6.0%	6.3%	3.8%	5.3%
Market Beta	1.00	1.09	1.01	0.94	0.52
Average Positions	1000.0	1000.0	1000.0	82.7	62.4
Effective N	138.5	1000.0	933.5	46.7	36.0

Source: Steven Thorley at BYU in Provo, UT

Are risk parity strategies superior to the equal weighted concept? Only if you can accurately predict the future. And who can do this constistently?

Who can accurately forecast the rel. out-of-sample volatilities and correlations?

Exhibit 12. Out-of-sample Diversification Ratios (13 assets, 2005–2012)



Source: Putnam.

Once again, the key is the accuracy of the predictions for the covariance matrix. As we have throughout, let us assume that the expected Sharpe Ratios are equal for all asset classes. If you believe that you cannot accurately forecast the relative out-of-sample volatilities, then you should use an equal-weighted portfolio. If you believe you can get the volatilities right, but not the correlations, then you should use Volatility Parity or Risk Parity. If you believe you can make reasonably accurate correlation forecasts, then Correlation Parity is the correct portfolio solution to maximize diversification and a superior choice to Risk Parity.

Source: Parity strategies and max. diversification (Robert J. Schoen, Putnam, June 2013 white paper)

Conclusion:

Key is the **accuracy of the predictions** for the covariance matrix. **Keep it simple** and stick to the **equal weighted allocation** without any predictions.

Prediction is very difficult, especially about the future. (Niels Bohr)

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