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Using Active Asset Allocation to Take Advantage of Market Extremes

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The importance of asset allocation – how a portfolio is divided among various asset classes - is widely understood. Experienced investors know that asset allocation is the key factor in portfolio performance and that superior risk-adjusted returns are achieved by combining uncorrelated asset classes in a balanced portfolio. Disciplined, methodical asset allocation has proven effective through all market environments. There is little disagreement about any of these points. What does arouse controversy is the question of whether asset allocation ought to be a passive or active activity.

Proponents of passive allocation argue that markets are efficient and that it is impossible to predict asset class performance. Therefore, it is unwise to engage in active asset allocation, especially in light of the higher transaction costs and tax liabilities that result from more frequent portfolio changes. Passive asset allocators believe that investors should determine a suitable mix of asset classes, rebalance periodically, and spend time on other pursuits. To a practitioner of this style of investment, active asset allocation seems to be just another name for market timing.

There is a great deal of validity to a passive asset allocation strategy, especially compared with the flawed approaches so many investors continue to pursue. However, a strictly passive approach to asset allocation fails to account for the fact that asset classes periodically reach extreme levels of overvaluation and undervaluation. These situations don't occur often, but when they do occur, they provide opportunities for an alert investor to make tactical asset allocation adjustments that have a high-probability of increasing returns or reducing risk.

Extreme Asset Class Valuations over the Past Five Years

The past five years have provided several examples of extreme asset class valuations – the most glaring of course being the overvaluation of large cap growth stocks in general and technology stocks in particular in the late 1990s. At the end of 1999, the price-to-book value multiple of the S&P 500/Barron's Growth Index reached the astounding level of 14.7x (versus a long-range average of approximately 3x), creating one of the most unfavorable risk/reward relationships in financial history. Fortunately, value-conscious investors had many attractive alternatives in 1999, including bonds, real estate investment trusts (REITs), value stocks, small-cap stocks, and even cash, which at the time was yielding over 5%.

More recent examples of extreme asset class valuations include:

1. The undervaluation of REITs in late 1999/early 2000
2. The subsequent overvaluation of REITs from mid-2003 to early 2004
3. The undervaluation of emerging markets stocks beginning in late 2001
4. The undervaluation of high-yield bonds throughout 2001 and 2002
5. The overvaluation of investment-grade bonds beginning in mid-2003

Each of these instances of overvaluation or undervaluation was recognizable using *relative* valuation analysis at the asset class level. Relative valuation analysis compares the current valuation of an asset class to both i) the historical valuation range for that asset class and ii) the current valuations of other asset classes.

REITs as an Illustration

In recent years, REITs have provided a case study of how relative valuation analysis can assist an investor in determining whether to over-weight, under-weight or neutral-weight a particular asset class in a portfolio. Two typical methods of valuing REITs are: i) to measure their stock market value relative to the underlying market values of their real estate assets; and ii) to compare their dividend yield to the benchmark 10-year Treasury bond yield. The former approach, which is illustrated in Exhibit 1, measures whether REITs are trading at a premium or discount to their underlying net asset value. It does not directly consider other asset classes. The latter approach, which is illustrated in Exhibits 2 & 3, compares the yield available from REITs to another income-oriented asset class – in this case the 10-year Treasury yield. This yield comparison can also be made between REITs and other income-producing investment alternatives, such as corporate bonds or dividend-paying, value-oriented stocks.

Exhibit 1

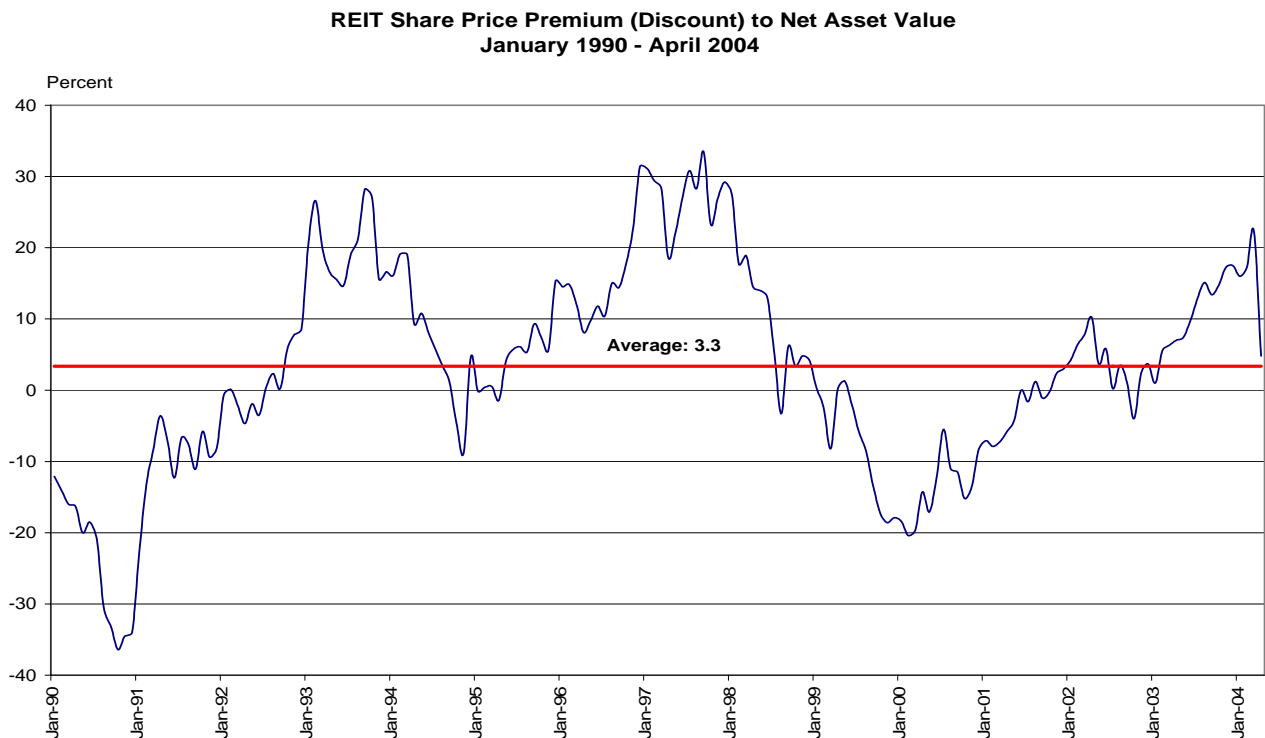


Exhibit 2

REIT Dividend Yield v. 10-Year Treasury Yield
January 1990 - April 2004

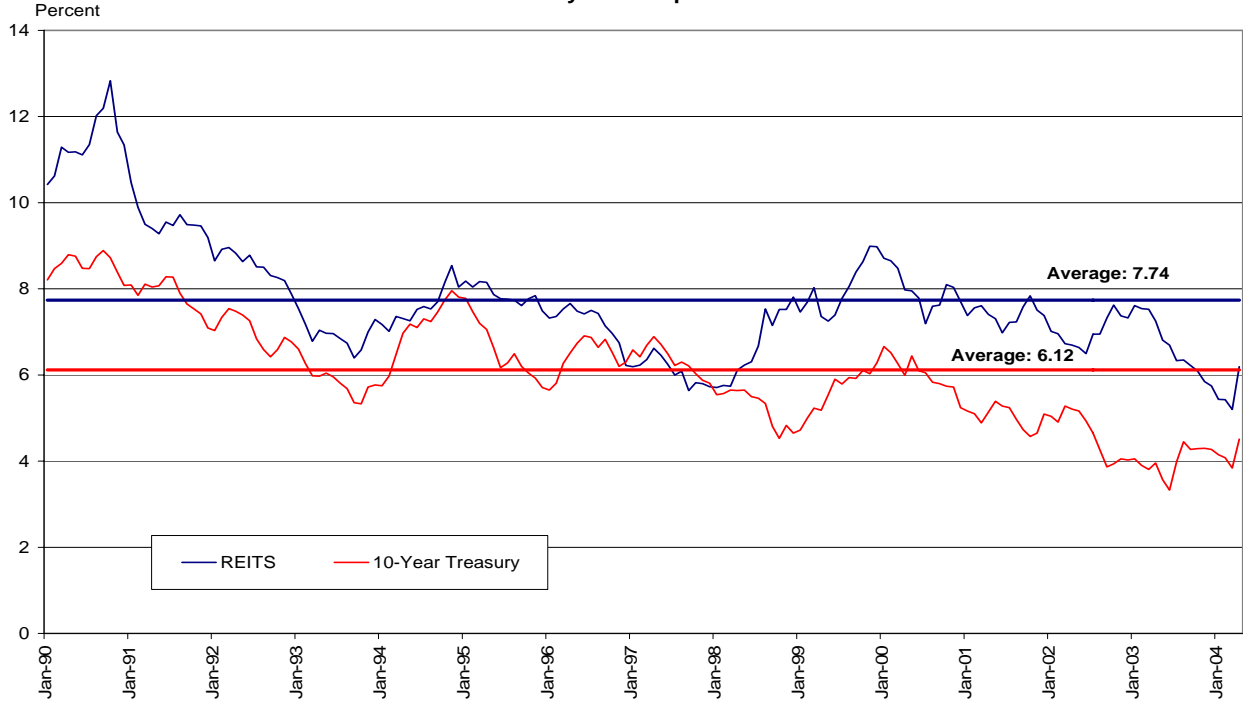
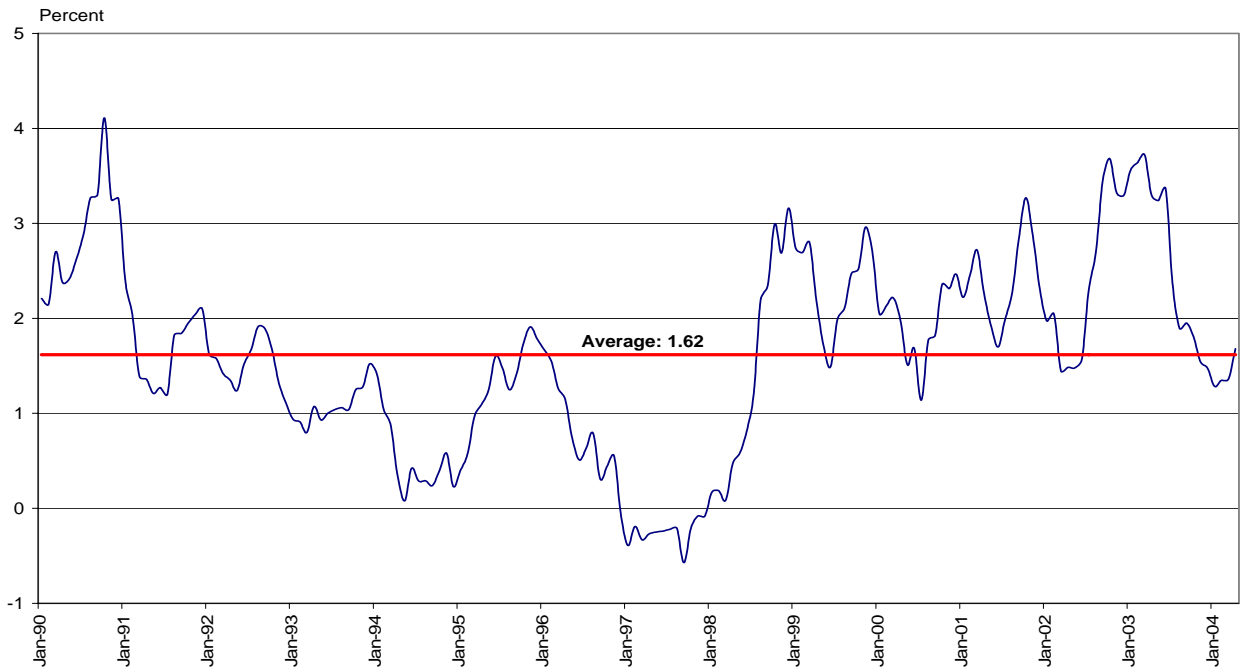


Exhibit 3

REIT Yield minus 10-Year Treasury Yield
January 1990 - April 2004



An examination of Exhibit 1 reveals that historically REITs have traded on average at a slight premium to their underlying net assets, presumably reflecting the value added by professional management of a portfolio of real estate holdings. Since 1990, this premium has averaged 3.3%, but REITs at various times have traded at much larger premiums, as well as substantial discounts. The principal forces driving these swings in valuation are the fundamentals of the real estate market and investors' enthusiasm for REITs versus other investment choices.

Judging from Exhibit 1, the "extremes" in valuation seem to occur when discounts to NAV reach 10% and when premiums to NAV reach 20%. The REIT market has seen both of these extremes over the past five years. Relative to NAV, REITs reached their cheapest levels in ten years in early 2000, presenting a very attractive investment opportunity, particularly compared with the overvaluations at the time elsewhere in the equity markets. In the four year period from 2000 to 2003, REITs were the best performing asset class bar none, producing a total return of 78%.

As a result of steadily higher prices, REITs' yields fell substantially over this period – from almost 9% to below 5.5%. Meanwhile, REITs' premium to NAV climbed above 10% in July 2003, providing a signal to REIT investors to adopt a more cautious posture. When the REIT yield fell below 6% in November 2003, an alert investor should have become very circumspect. REITs had only traded at sub-6% yields for a total of seven months in the past 30 years.

Despite these warning signs, REIT stocks continued to appreciate into early 2004, tracking the protracted overvaluation in the bond market. Indeed, an examination of Exhibit 3 reveals that relative to Treasury yields, REIT yields in late 2003 and early 2004 were right in line with their historical average spread. As long as rates remained at 40-year lows, REITs were able to move higher, ultimately reaching a very extreme 20% premium to NAV before prices collapsed along with the bond market in April 2004, quickly taking the premium back down to its historical average.

Conclusions

Provided the investor has a sound analytical basis for making a portfolio change, an active rather than a passive approach to asset allocation should enhance risk-adjusted returns over time. Since asset class performance is notoriously unpredictable, and since asset classes can remain overvalued or undervalued for extended periods of time, active asset allocation should be based on high-probability situations where an asset class has reached an extreme over- or under-valuation. Such extremes do occur because markets are efficient most but not all of the time.

Are there any extreme valuations in asset classes today? The recent sharp correction in the bond market and interest-rate sensitive sectors like REITs relieved the most obvious area of over-valuation. Outside of residential real estate in a number of markets, most asset classes appear to be fully valued thanks to the reflationary efforts of governments worldwide, which have produced the liquidity to drive asset values higher.

The current appeal of equities is based largely on the very low interest rate environment. Relative to 1% money markets and 4-5% intermediate bonds, stocks seem reasonable,

even attractive. But such relative comparisons should not form the full basis of prudent investment decisions. Using traditional, absolute standards of valuation - price/earnings, price/book and dividend yield – stocks are fully priced, and domestic stocks are more fully priced than international stocks. All in all, it seems to be an environment that argues for caution and patience.

05/28/2004

J.D. Steinhilber is the founder of AgileInvesting.com, an investment advisory web site that conducts asset class research and recommends ETF-based portfolios.