

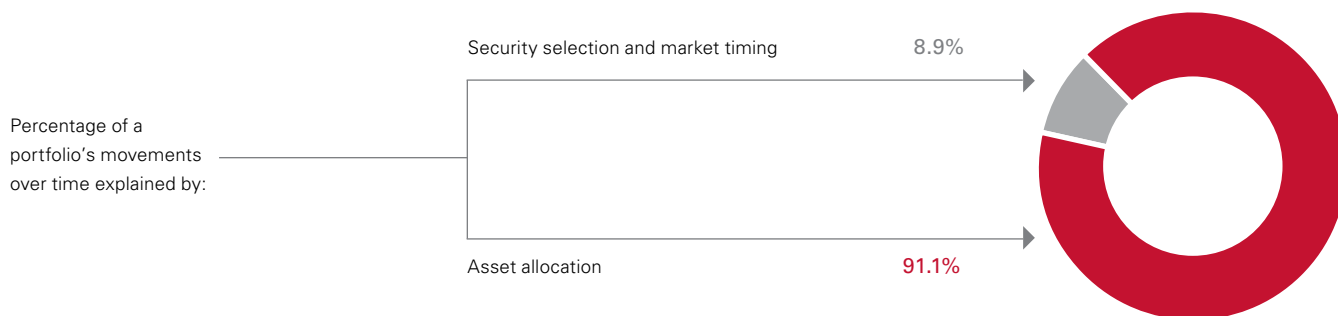
The importance of asset allocation

When building a portfolio to meet a specific objective, it is critical to select a combination of assets that offers the best chance for meeting that objective, subject to the investor's constraints.² Assuming that the investor uses broadly diversified holdings, the mix of those assets will determine both the returns and the variability of returns for the aggregate portfolio.

This has been well documented in theory and in practice. For example, the seminal 1986 study by Brinson, Hood, and Beebower was confirmed by Scott et al. (2017), a paper that showed that the asset allocation decision was responsible for 91.1% of a diversified portfolio's return patterns over time (Figure 4).

FIGURE 4

Investment outcomes are largely determined by the long-term mixture of assets in a portfolio



Notes: Calculations are based on monthly returns for 709 American funds from January 1990 to September 2015. More details of the methodology were presented in Scott et al. (2017).
Sources: Vanguard calculations, using data from Morningstar, Inc.

² For asset allocation to be a driving force of an outcome, one must implement the allocation using vehicles that approximate the return of market indexes. This is because market indexes are commonly used in identifying the risk and return characteristics of asset classes and portfolios. Using a vehicle other than one that attempts to replicate a market index will deliver a result that may differ from the index result, potentially leading to outcomes different from those assumed in the asset allocation process. To make the point with an extreme example: Using a single stock to represent the equity allocation in a portfolio would likely lead to very different outcomes than either a diversified basket of stocks or any other single stock.