How Wealthier Americans Invest

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I recently read a fascinating survey by Northern Trust (NTRS) called ***Wealth in America 2007*** (link provided at the end of this article). This survey examines the investing attitudes and behaviors of wealthy Americans, in this case defined as households with investable assets of at least $1 million. Granted, this is not a small group: the report states that there are 4.1 million households in this group, with the average having $3 million in liquid assets. Demographic information on these investors is provided. Not surprisingly, most of the people (61%) who completed the survey were in their 50's and 60's, and a further 18% were in their 40's. The remaining respondents were about evenly split between being younger than 40 (10%) and 70 or older (11%). 35% of these millionaire households had already received a sizeable inheritance and an additional 25% of households expect to receive an inheritance in the future with an average expected value of $850,000. 34% of these households reported annual income of $149K or less, while 30% reported annual income of $250K or more. As a group, these investors tend to be well-educated: 28% have postgraduate degrees and a further 36% achieved a four-year college degree as their highest level of education. The two most commonly reported occupations of the respondents were senior corporate executive, business owner, and consultant, although these categories account for only 40% of the population.

What we have here is a population of people who are in top tier of wealth in America, by any measure. The survey results that show how these people invest are very interesting. Before starting to look at the attitudes of these investors, consider where your current thinking on this topic may come from. If you read the popular investing press, you may think that wealthier Americans are investing heavily in the most 'exciting' asset classes such as emerging markets or alternative investments (hedge funds, commodities, etc). You may think that a large fraction of millionaires are heavily invested in real estate. The survey results paint a very different picture of how the wealthy invest and how they think about asset allocation than the financial media tends to suggest.

The asset allocations of wealthy Americans in this survey are far more focused on domestic equities than many people might suppose:

Asset Class	Percentage
Domestic Equities	43%
Bonds	15%
Cash	13%
International Equities	10%
Investment Real Estate	8%
Private Equity	6%
Commodities	2%
Other	2%
Hedge Funds	1%
Sum	100%

Average asset allocation of wealthy Americans (2006, source: Northern Trust)

The respondents to the survey are not investing heavily in bonds, international equities, or real estate—at least not by current standards. This asset allocation is quite different than you will see in most asset allocation articles and books. Forty one percent of these investors said that their most important goal was to increase overall wealth, while 31% said that their most important goal was to protect current wealth. Naturally, this rating of priorities is a function of age, with younger investors tending to place higher importance on growth whereas older investors tend to place higher importance on wealth preservation.

From what I observe, the financial media tends to be driven largely by a 'backward' view. Well-known financial author and professor Jeremy Siegel has been advocating that investors put as much as 40% of their equity portfolios in foreign stocks:

http://finance.yahoo.com/expert/article/futureinvest/18829

Obviously this strategy would have been great in recent years, but why is this so different from the wealthy investors in this survey? Even if you are fairly heavily invested in bonds (say with 40% in bonds), allocating 40% of your equity portfolio to foreign stocks means 24% of your total portfolio in foreign stocks—far more than the average of the wealthy investors in this survey.

The wealthy investors from this survey tend to have a low allocation to bonds (15%, shown above), even though almost three quarters (72%) of the respondents are age fifty or older. Compared to the types of guidelines that you will see in most books and articles, this is a low allocation to bonds.

Interestingly, a fairly low allocation to bonds and a conservative approach to investment in international equities (at least relative to the current environment) are both consistent with investors who take a cohesive 'portfolio view' of their investing rather than following conventional wisdom or trying to chase the latest high performing asset class. More experienced (and wealthier) investors are, I believe, more likely to grasp the importance of how the pieces of their portfolio work together and serve their broader goals. When you analyze portfolios using a broad view, such as with a portfolio analysis tool, it is rather clear that a high allocation to bonds tends to give up too much in return and that a high allocation to international equities can increase portfolio risk to unacceptable levels because of the high correlation between the U.S. market and foreign markets.

When you look at a portfolio in aggregate, using a tool like Quantext Portfolio Planner (QPP), you tend to take a different view of diversification. The value of diversification is to maximize the return that you can achieve relative to the risk in the portfolio. Many investors think that international equity markets provide them with diversification, but often that is not the case. There are broad classes of U.S. equities, such as utilities and natural resources, which have lower correlation (and therefore better diversification) to the S&P500 than broad international indices:

http://www.quantext.com/Correlation.pdf

This article shows that EFA, which tracks the EAFE index, has a dramatically higher correlation to the S&P500 (82%) than IDU (36%), which tracks the Dow Jones Utilities Index, or IGE (41%), a natural resources index ETF. From the standpoint of portfolio diversification, simply investing in the broad markets in other countries may not be all that valuable. Many investors learned that the hard way in early 2007, but this is not a new phenomenon. I believe that more sophisticated investors are more likely to grasp this, and act accordingly.

With regard to the relatively low allocation to bonds among these investors, a similar explanation is available. The most basic explanation for investing in bonds is that bonds tend to have zero (or slightly negative) correlation to the broader market and zero Beta. Vanguard's intermediate bond index fund, VBIIX, has a correlation of -12% to SPY (the S&P500 ETF) and a -24% correlation to QQQQ, which tracks the NASDAQ 100, over the last four years (values are taken from the article cited above). Because bonds have low Beta and low correlation to the broad equity indices, they seem to provide an obvious way to manage risk in the equity markets. The problem is that you also give up a great deal of return when you invest in bonds. An alternative to bonds is to identify stocks which have high dividend yields and low Betas. Our research using QPP has shown that it is often preferable to build a portfolio of this type of domestic stocks rather than investing heavily in bonds:

http://www.quantext.com/SampleLowBeta.pdf

In the article above, we show a portfolio with a fairly modest bond allocation (19%), but that moves largely independently of the moves in the broader U.S. market. By incorporating stocks like Johnson and Johnson (JNJ) and Bank of America (BAC), which have low correlation to the S&P500 and to each other, we were able to build a very well diversified portfolio—meaning that it generates high average return relative to portfolio risk. When analyzing portfolios in this kind of framework, it is often the case that well-chosen domestic stocks provide high levels of diversification. A high allocation to bonds, in this context, often represents a less than optimal choice.

Sophisticated investors are more likely to understand that short-term 'market risk' tends to be overwhelmed by long-term growth over time, so that more aggressive portfolios are often actually less risky in the long-haul:

http://www.quantext.com/RiskChoices.pdf

The implications of this idea are reflected in the fairly low allocation of the wealthy to bonds. In the short-term, a higher allocation to bonds decreases swings in portfolio value. In the long-term, a higher allocation to bonds decreases compound growth to the point that the reduction in short-term risk is not a worthwhile tradeoff. In the article cited above, for example, we found that simple portfolio allocation with 10% invested in inflation-protected bonds (TIP) over twenty five years had about the same worst case outcomes as an investor with 30% in TIP, but the portfolio with only 10% in TIP had a far higher average value. This effect is increasingly noted in the institutional investor literature (such as the Alliance-Bernstein study cited in the article above), and wealthier investors and their advisors are far more likely to be familiar with this work.

When I first read the ***Wealth in America 2007*** survey, I was struck by the fact that the asset allocations across this population were remarkably consistent with the types of allocations that Quantext Portfolio Planner (QPP) has given high marks to in our research. QPP tends not to advocate high allocation to bonds, because you can get their diversification benefits through a strategic allocation to low-Beta stocks. QPP tends to be fairly conservative in terms of endorsing broad investment in foreign markets because of the fairly high correlation of these markets to the U.S. market and because of the potential for very high volatility, especially in emerging markets. The portfolios that QPP tends to give highest marks to have heavy allocations, in aggregate, in U.S. equities. QPP agrees with a fairly conservative allocation to real-estate as an asset class, similar to the wealthy investors in this survey. Real estate is an asset class that has a place in a portfolio, but it is not worthy of enormous allocations in the long-term.

QPP endorses asset allocations that are far more similar to the asset allocations of the wealthy investors in the Northern Trust study than to much of what I see proposed in popular financial literature. Why is this? QPP provides a holistic portfolio view of an asset allocation plan and also tends to take the long view, with a tendency to discount recent performance. This approach is not new or novel in the world of finance—these ideas have been widely understood for at least four decades in the form of portfolio theory. For most individual investors (and many advisors), however, portfolio theory remains an abstract concept. I believe that wealthier investors and their advisors tend to be more knowledgeable in these areas, which explains why we see a convergence between the broad asset allocations endorsed by QPP and those of wealthier Americans.

Note: readers should understand that the comments regarding appropriate asset allocations to foreign equities should be understood in the context of broad risk-return tradeoffs in the portfolios of the age range predominant in this survey. Foreign, and especially, emerging economies have enormous potential return—and consequently high levels of risk. The optimal risk-return balance and appropriate asset allocations for any individual must be determined by his/her specific goals and attributes.

Full survey from Northern Trust
http://www-ac.northerntrust.com/content//media/attachment/data/white_paper/0702/document/wealth_america2007.pdf

Disclosure: the author holds JNJ and BAC in his portfolio.

Quantext Portfolio Planner *is a Monte Carlo portfolio management tool. Extensive case studies, as well as access to a free extended trial, are available at http://www.quantext.com/gpage3.html*