An Asset Allocation Puzzle

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This paper examines popular advice on portfolio allocation among cash, bonds, and stocks. It documents that this advice is inconsistent with the mutual-fund separation theorem, which states that all investors should hold the same composition of risky assets. In contrast to the theorem, popular advisors recommend that aggressive investors hold a lower ratio of bonds to stocks than conservative investors. The paper explores various possible explanations of this puzzle. It concludes that the portfolio recommendations can be explained if popular advisors base their advice on the unconditional distribution of nominal returns. It also finds that the cost of this money illusion is small, as measured by the distance of the recommended portfolios from the mean-variance efficient frontier.

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