Asset Allocation

If you're like most investors, you have different types of assets. Because one type of asset behaves differently from another in terms of risk and return, it's important to strategically plan what portion of your investment portfolio you'll dedicate to each type of asset.

This portioning is called asset allocation. The asset allocation you choose for your own portfolio is a personal decision based mostly on your investment objectives and constraints, including your investment horizon and risk tolerance. Asset allocation is not synonymous with diversification—asset allocation is the vehicle through which your portfolio can become diversified. However, you may choose to allocate your assets so that they aren't diversified for various reasons. For instance, you could choose to hold 100 percent of your investment in stocks—here, you have allocated your assets but not diversified. An undiversified portfolio like this is not optimal because it takes on too much risk, so diversification is an important strategy in asset allocation.

Why is it Important?

Many studies have indicated that asset allocation is the primary driver of variation for a diversified portfolio's quarterly returns. This means that, in the short-term, asset allocation is extremely important, more so than which individual securities you purchase. Proper asset allocation can provide the necessary diversification to prevent your investment from falling victim to the market's short-term volatility. It's easier to go about diversifying your portfolio when you first decide what percentage of each type of asset you'll hold. Historically, different asset categories perform differently from each other at any given time. You are unlikely to lose your whole investment at once because one asset class doesn't normally affect the performance of another.

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Types of Assets

With so many different asset categories, there are infinite ways to divide your portfolio. A simplified asset allocation might be 60 percent stocks, 30 percent bonds and 10 percent cash. But this example portfolio is more complicated than that, and its assets might be allocated differently from another 60/30/10 portfolio. Stocks range in volatility from large cap value to small cap growth and bonds range in maturity date (short-term to long-term), so diversification within asset classes is also important. Investments held in "cash," can mean money held in a savings account, a CD, a money

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market account or government bonds. In addition to the three main asset classes, you can invest in real estate, commodities, precious metals, collectibles, foreign stocks, and alternative assets. Each asset class behaves differently and will impact your portfolio differently, depending on what percentage you allocate to them.

Things to Consider

All investors are unique, and since there are infinite ways to allocate your assets, your portfolio can be unique too. That said, there are some objectives and constraints to consider when choosing your investments:

- Your time horizon is important when choosing your asset allocation. If you'll need to liquidate soon (such as if you're saving for a family vacation or if you'll be retiring in the next few years), you'll want to minimize your exposure to risk. If your time horizon is long (if you'll be retiring in 30 years, for instance), you can tolerate higher risk exposure.
- Your risk tolerance is also important. Risk tolerance is your ability to lose some or all of your investment due to market fluctuations. Your ability is determined both by your financial outlook and your emotional reaction to risk.
- In general, riskier investments yield higher returns.
- There is no perfect asset mix. There's no way to tell what the perfect asset allocation will be, and even if you could, the market is always changing.
- When your portfolio is new—your investment is small and your time horizon is long—you can afford to take on risk, and market volatility matters less.
- When your investment has grown and/or you'll need to liquidate soon, your focus should be on preserving your investment.
- Of the three main asset classes, stocks are usually the riskiest, followed by bonds, then cash. Generally, you will start out with a high percentage of stocks and gradually transition to holding more bonds throughout the life of your investment.
- Cash and cash equivalents are the least risky, and many cash equivalent investments are insured by the FDIC. The main risk in this type of asset is that inflation will outpace growth.

Asset Allocation Strategies

You can shape your portfolio based on one of the four main asset allocation strategies that take into account both time horizon and risk tolerance. You'll need to work with a financial advisor to personalize your portfolio, but these strategies are a good starting point:

- **Growth:** This model focuses on building long-term wealth by increasing risk exposure. You would choose this asset allocation if you knew you wouldn't need access to your money in the near future. A growth-focused portfolio tends to invest in a high percentage of stocks, which carry both high risk and high return.
- **Income:** As you get closer to retirement, your investment may need to become more conservative. You'll be dipping into your savings sooner and thus have a lower tolerance for risk. These portfolios are designed to generate income from assets such as stocks that pay regular dividends.
- **Balanced:** A cross between growth and income is the balanced portfolio, which both grows and generates cash. This asset mix appeals to investors' emotional sides and offers diversification.
- **Preservation of Capital:** If you're nearing retirement (or if your investment is for a short-term goal), you'll want to focus on preserving the capital you have, rather than building more. These portfolios have a high percentage of cash and cash equivalents, with little risk.

Whatever your situation—your age, risk tolerance, savings goals etc.—there is an asset allocation model that should work for you, in theory. However, it's up to you and your financial advisor to determine your individual investing needs and allocate your assets accordingly. Once you've chosen your proper asset allocation, keep in mind that you'll need to update it periodically as your needs change. This will help keep your investments relevant to you and keep you an informed investor.

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