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Asset Allocation Broken Down

Reality check: If your financial advisor, stock broker or hedge fund manager was able to see the future and know which way the market was heading, they wouldn't be managing your money.

Instead they would invest the farm on their market prediction and ride off into the sunset.

That is the cold hard truth….

And because they cannot see the future (even thought they might continue to tell you otherwise) they should be helping you invest your money in an appropriate asset allocation portfolio tailored to your goals and objectives.

What the heck does that mean

Allow me to break it down for you.

The basics of asset allocation

The idea behind asset allocation is that because not all investments are alike, you can balance risk and return in your portfolio by spreading your investment dollars among different types of assets, such as stocks, bonds, and cash alternatives. It doesn't guarantee a profit or ensure against a loss, of course, but it can help you manage the level and type of risk you face.

In my experience, that is the most important piece of the puzzle. If your portfolio behaves in a way you expect (knowing that it can up and down) should prevent you from making bad, irrational investment decisions.

Different types of assets carry different levels of risk and potential for return, and typically don't respond to market forces in the same way at the same time.

For instance, when the return of one asset type is declining, the return of another may be growing (though there are no guarantees). If you diversify by owning a variety of assets, a downturn in a single holding won't necessarily spell disaster for your entire portfolio.

Using asset allocation, you identify the asset classes that are appropriate for you and decide the percentage of your investment dollars that should be allocated to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives).

The three major classes of assets

Here's a look at the three major classes of assets you'll generally be considering when you use asset allocation.

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Stocks: Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return than other investments, including bonds and cash alternatives. However, stocks are generally more volatile than bonds or cash alternatives. Investing in stocks may be appropriate if your investment goals are long-term.

Bonds: Historically less volatile than stocks, bonds do not provide as much opportunity for growth as stocks do. They are sensitive to interest rate changes; when interest rates rise, bond values tend to fall, and when interest rates fall, bond values tend to rise. As a result, bonds redeemed prior to maturity may be worth more or less than their original cost. Because bonds typically offer fixed interest payments at regular intervals, they may be appropriate if you want regular income from your investments.

Cash alternatives: Cash alternatives (or short-term instruments) offer a lower potential for growth than other types of assets but are the least volatile. They are subject to inflation risk, the chance that returns won't outpace rising prices. They provide easier access to funds than longer-term investments, and may be appropriate for investment goals that are short-term.

Not only can you diversify across asset classes by purchasing stocks, bonds, and cash alternatives, you can also diversify within a single asset class.

For example, when investing in stocks, you can choose to invest in large companies that tend to be less risky than small companies. Or, you could choose to divide your investment dollars according to investment style, investing for growth or for value. Though the investment possibilities are limitless, your objective is always the same: to diversify by choosing complementary investments that balance risk and reward within your portfolio.

Decide how to divide your assets

Your objective in using asset allocation is to construct a portfolio that can provide you with the return on your investment you want without exposing you to more risk than you feel comfortable with. How long you have to invest is important, too, because the longer you have to invest, the more time you have to ride out market ups and downs.

When you're trying to construct a portfolio, you can use worksheets or interactive tools that help identify your investment objectives, your risk tolerance level, and your investment time horizon. These tools may also suggest model or sample allocations that strike a balance between risk and return, based on the information you provide.

For instance, if your investment goal is to save for your retirement over the next 20 years and you can tolerate a relatively high degree of market volatility, a model allocation might suggest that you put a large percentage of your investment dollars in stocks, and allocate a smaller percentage to bonds and cash alternatives. Of course, models are intended to serve only as general guides; determining the right allocation for your individual circumstances may require more sophisticated analysis.

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Build your portfolio

The next step is to choose specific investments for your portfolio that match your asset allocation strategy. Websites like Morningstar.com or finance.google.com (not endorsed by IFS securities) you can investigate most of the funds available to you in your brokerage or retirement accounts. You can search by asset class, risk level etc..

Pay attention to your portfolio

Once you've chosen your initial allocation, revisit your portfolio at least once a year (or more often if markets are experiencing greater short-term fluctuations). One reason to do this is to rebalance your portfolio. Because of market fluctuations, your portfolio may no longer reflect the initial allocation balance you chose. For instance, if the stock market has been performing well, eventually you'll end up with a higher percentage of your investment dollars in stocks than you initially intended. To rebalance, you may want to shift funds from one asset class to another.

In some cases you may want to rethink your entire allocation strategy. As you get older or just closer to end date of your goals you should make sure the allocation strategy is still appropriate for you.

Wrap Up

Money is lost in the markets due to emotional decisions that cause us to take action at the wrong times. Building a properly allocated portfolio is one of the major keys to investment success. Investing is not about loading up on one investment that you think (guess) is going to sky rocket, it's about building a portfolio that will perform in manner that you can expect and handle.

Let's start the conversation!

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