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RETIREMENT & INSURANCE SERVICES, INC.

Balancing Your Investment Choices with Asset Allocation



Even if your asset allocation was right for you when you chose it, it may not be appropriate for you now. It needs to change as your circumstances and priorities change.

Asset allocation and diversification cannot guarantee a profit or insure against a loss. There is no guarantee that any investment strategy will be successful; all investing involves risk, including the possible loss of principal.

A chocolate cake. Pasta. A pancake. They're all very different, but they generally involve flour, eggs, and perhaps a liquid. Depending on how much of each ingredient you use, you can get very different outcomes. The same is true of your investments. Balancing a portfolio means combining various types of investments using a recipe that's appropriate for you.

Getting an appropriate mix

The combination of investments you choose can be as important as your specific investments. The mix of various asset classes, such as stocks, bonds, and cash alternatives, accounts for most of the ups and downs of a portfolio's returns.

There's another reason to think about the mix of investments in your portfolio. Each type of investment has specific strengths and weaknesses that enable it to play a specific role in your overall investing strategy. Some investments may be chosen for their growth potential. Others may provide regular income. Still others may offer safety or simply serve as a temporary place to park your money. And some investments even try to fill more than one role. Because you probably have multiple needs and desires, you need some combination of investment types.

Balancing how much of each you should include is one of your most important tasks as an investor. That balance between growth, income, and safety is called your asset allocation, and it can help you manage the level and type of risks you face.

Balancing risk and return

Ideally, you should strive for an overall combination of investments that minimizes the risk you take in trying to achieve a targeted rate of return. This often means balancing more conservative investments against others that are designed to provide a higher return but that also involve more risk. For example, let's say you want to get a 7.5% return on your money. Your financial professional tells you that in the past, stock

market returns have averaged about 10% annually, and bonds roughly 5%. One way to try to achieve your 7.5% return would be by choosing a 50-50 mix of stocks and bonds. It might not work out that way, of course. This is only a hypothetical illustration, not a real portfolio, and there's no guarantee that either stocks or bonds will perform as they have in the past. But asset allocation gives you a place to start.

Someone living on a fixed income, whose priority is having a regular stream of money coming in, will probably need a very different asset allocation than a young, well-to-do working professional whose priority is saving for a retirement that's 30 years away. Many publications feature model investment portfolios that recommend generic asset allocations based on an investor's age. These can help jump-start your thinking about how to divide up your investments. However, because they're based on averages and hypothetical situations, they shouldn't be seen as definitive. Your asset allocation is--or should be--as unique as you are. Even if two people are the same age and have similar incomes, they may have very different needs and goals. You should make sure your asset allocation is tailored to your individual circumstances.

Many ways to diversify

When financial professionals refer to asset allocation, they're usually talking about overall classes: stocks, bonds, and cash or cash alternatives. However, there are others that also can be used to complement the major asset classes once you've got those basics covered. They include real estate and alternative investments such as hedge funds, private equity, metals, or collectibles. Because their returns don't necessarily correlate closely with returns from major asset classes, they can provide additional diversification and balance in a portfolio.

Even within an asset class, consider how your assets are allocated. For example, if you're investing in stocks, you could allocate a certain amount to large-cap stocks and a different percentage to stocks



of smaller companies. Or you might allocate based on geography, putting some money in U.S. stocks and some in foreign companies. Bond investments might be allocated by various maturities, with some money in bonds that mature quickly and some in longer-term bonds. Or you might favor tax-free bonds over taxable ones, depending on your tax status and the type of account in which the bonds are held.

Asset allocation strategies

There are various approaches to calculating an asset allocation that makes sense for you.

The most popular approach is to look at what you're investing for and how long you have to reach each goal. Those goals get balanced against your need for money to live on. The more secure your immediate income and the longer you have to pursue your investing goals, the more aggressively you might be able to invest for them. Your asset allocation might have a greater percentage of stocks than either bonds or cash, for example. Or you might be in the opposite situation. If you're stretched financially and would have to tap your investments in an emergency, you'll need to balance that fact against your longer-term goals. In addition to establishing an emergency fund, you may need to invest more conservatively than you might otherwise want to.

Some investors believe in shifting their assets among asset classes based on which types of investments they expect will do well or poorly in the near term. However, this approach, called "market timing," is extremely difficult even for experienced investors. If you're determined to try this, you should probably get some expert advice--and recognize that no one really knows where markets are headed.

Some people try to match market returns with an overall "core" strategy for most of their portfolio. They then put a smaller portion in very targeted investments that may behave very differently from those in the core and provide greater overall

diversification. These often are asset classes that an investor thinks could benefit from more active management.

Just as you allocate your assets in an overall portfolio, you can also allocate assets for a specific goal. For example, you might have one asset allocation for retirement savings and another for college tuition bills. A retired professional with a conservative overall portfolio might still be comfortable investing more aggressively with money intended to be a grandchild's inheritance. Someone who has taken the risk of starting a business might decide to be more conservative with his or her personal portfolio.

Things to think about

- Don't forget about the impact of inflation on your savings. As time goes by, your money will probably buy less and less unless your portfolio at least keeps pace with the inflation rate. Even if you think of yourself as a conservative investor, your asset allocation should take long-term inflation into account.
- Your asset allocation should balance your financial goals with your emotional needs. If the way your money is invested keeps you awake worrying at night, you may need to rethink your investing goals and whether the strategy you're pursuing is worth the lost sleep.
- Your tax status might affect your asset allocation, though your decisions shouldn't be based solely on tax concerns.

Even if your asset allocation was right for you when you chose it, it may not be appropriate for you now. It should change as your circumstances do and as new ways to invest are introduced. A piece of clothing you wore 10 years ago may not fit now; you just might need to update your asset allocation, too.

No simple answers

You may have heard this widely known rule of thumb: To figure out the percentage of your investments that should be in stocks, subtract your age from 100. However, this is hardly a comprehensive strategy. Deciding on an appropriate asset allocation involves more than simply looking at your age. Your financial professional can help you choose a combination that takes into account your goals, risk tolerance, and overall financial situation.

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