

Asset allocation: Investing with discipline

Published December 2008

In today's markets, investing with discipline involves selecting investments that are in line with an overall asset allocation and diversification strategy based upon your needs, goals, time frames and your ability to assume risk. To meet goals, investors must identify their financial objectives and an investment mix to help them achieve those goals.

Of course, when it comes to investing, greater reward generally carries greater risk. So if you're looking for a smart way to reduce investment volatility, while still retaining profit potential, then consider the advantages of asset allocation.

Benefits of Asset Allocation

Asset allocation is the process of deciding what percentage of your money to put into the three major asset classes: stocks, bonds and cash. The three classes can be further broken down into terms of market capitalization (small-cap, mid-cap, and large-cap), style (such as value or growth investing), and international or domestic securities.

Because each type of asset responds differently to shifts in the economy and financial markets, some investments may be up while others may be down. With asset allocation, a portfolio may experience less fluctuation in value than individual assets within the portfolio.

This investment technique may have a significant impact on the ultimate success of your portfolio. In fact, asset allocation has more influence on portfolio variance than any other single investment decision. In an important study published by the research team of Brinson, Singer, and Beebower in 1991, asset allocation was shown to account for as much as 91.5 of the variation in total return, far outweighing other significant factors such as market timing and security selection.

Although each investor invests differently, the goals of asset allocation remain the same. For example, asset allocation may help you:

- Maximize portfolio return at a reasonable level of risk.
- Create a prudent diversification of investment assets.
- Meet stated financial goals such as education or retirement funding, and other objectives such as the purchase of a home.
- Accommodate your risk tolerance, investment time horizon and tax situation.

Even though investors may share common goals, they may need to apply different strategies based upon their personal factors. For example, if two investors are planning for retirement and one has a longer time frame to invest, he or she may be willing to utilize higher risk vehicles than someone who has a shorter time period to invest. Each investor must seriously consider their tolerance for risk, which includes their emotional comfort level in addition to financial abilities.

Developing Your Investment Strategies

Upon defining your time horizon, funds needed to meet goals, and planned current and future contributions, you can begin to determine appropriate asset classes and diversification strategies that will help develop the right portfolio for you.

There's also something more to consider: your tolerance for risk. For an investment strategy to work for you, it's imperative that you're comfortable with the risk you assume. Even though your financial situation may point toward a higher level of risk, your peace of mind might dictate a more conservative investment plan.

Investing today is about more than stock picks and bond selections. In fact, stocks and bonds are only a small part of the equation. The current investing environment offers numerous alternatives, and savvy investors recognize the many choices they have. Stock investments offer the highest potential returns with the greatest amount of risk. Fixed income investments respond to changes in interest rates. Money market funds have proven to offer stability; however, historically they have not produced returns much greater than the rate of inflation.

That's why it's important to spread investment dollars over various asset classes. While diversification does not ensure a profit or protect against loss, a combination of money market, fixed income and equity investments can provide potentially higher returns than either money market or fixed income investments alone.

Model Portfolios

Following are some model asset allocation portfolios:

Conservative. This type of portfolio is designed to focus on protecting principal (the assets within the portfolio) from loss of value and offers a higher degree of liquidity. Income generated by the portfolio is of secondary concern. The majority of investments – approximately 65 percent – are allocated to fixed income, with 10 percent to large cap stocks and the rest to cash. However, returns may be very low in exchange for a higher degree of liquidity and minimized risk to principal.

Moderately Conservative. Such a portfolio is designed to provide immediate income, and earnings are generally produced by interest and dividend payments. Fixed income investments comprise about 55 percent of this portfolio, large-cap stocks 25 percent, small- and midcap stocks 3.75 and 1.25 percent, respectively, and cash 15 percent. A slightly greater degree of risk is accepted in exchange for a greater opportunity to realize a modest positive rate of return. However, growth of the assets within the portfolio is of secondary concern.

Moderate. A moderate portfolio is designed to provide both current income and growth of portfolio assets. Fixed income accounts for approximately 45 percent of the portfolio, large-cap stocks for 30 percent, international stocks for 10 percent, small- and mid-cap

stocks 7.5 and 2.5 percent, respectively, and cash 5 percent. Generally, a possible risk of loss to principal is accepted in exchange for a possible higher average rate or return. Equal emphasis is placed on both current income and asset growth.

Moderately Aggressive. International and fixed income investments can each make up 20 percent of the portfolio, with large-cap stocks accounting for about 35 percent, small- and mid-cap stocks 15 and 5 percent, respectively, and cash 5 percent. This type of portfolio is designed to stress the capital appreciation of the assets within the portfolio. Assets that may not pay a current income, but have the potential for future growth, are the mainstays of such a portfolio.

Aggressive. Generally, assets in such a portfolio are more risky and do not pay current income, but have good potential for future growth. Large-cap stocks may comprise 35 percent of the portfolio, international and small-cap stocks 25 percent each, mid-cap stocks 10 percent, and cash 5 percent. Assets can be very volatile and often a loss of capital is experienced. Such a portfolio attempts to capture the historical long-term growth of the markets.

Asset Allocation in Your Long-Term Plans

While some investors fall into these general profiles, most actually fall in between such categories. Asset allocation does not eliminate risk. However, it is a strategy to help you invest with discipline. Asset allocation is not only important in your stock portfolio, but in all of your investments, such as 401(k)s, IRAs and college savings plans. Asset allocation is not a static strategy. To be effective, an asset allocation plan should be reviewed periodically. Also, any changes in your financial goals, lifestyle, time frame and financial circumstances, plus changes in market conditions, could necessitate revision of your asset allocation plan.

Cameron Short is a Senior Vice President/Investments in the Pittsburgh office of Stifel, Nicolaus & Company, Incorporated, member SIPC and New York Stock Exchange