

Asset Allocation Basics



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Your retirement nest egg shouldn't actually be one egg, but many, and you definitely don't want to put them all in one basket.

That's the philosophy behind asset allocation, the practice of dividing your retirement savings among different asset classes. You put one egg into stocks, another into bonds, yet another in real estate, and so on.

No, you won't end up with scrambled eggs. By spreading your money around into different categories of investments, you can minimize risk and maximize performance. How does this happen? When you diversify among investments with little correlation to one another, some assets will go up while others go down. When they move in opposition to one another, they have a negative correlation. In effect, this helps stabilize the portfolio and reduce overall volatility.

For example, studies show that Real Estate Investment Trusts (REITs) have little correlation to the stock market. "In '98, the stock market was going through the roof while Real Estate Investment Trusts were losing ground," says Doug Charney, senior vice president of the Charney Investment Group of Wachovia Securities. "The opposite was true in 2001 and 2002. Stocks were down while real estate was doing well."

Bonds also performed well during the two-year period when stocks were sucking wind.

Mitigating risk

That's why asset allocation is so important. "It doesn't eliminate risk, but it helps you deal with it," says Stuart Ritter, a certified financial planner with T. Rowe Price. "When something bad is happening in international stocks, your technology stocks may be doing well and the impact on your portfolio is lessened."

"Asset allocation is by far the most important thing that you can do." Investors often focus too much on choosing the right mutual fund rather than looking at how they are divvying up their retirement savings. It may not be as much fun as choosing the next high-flying, emerging markets fund or acting on a hot stock tip from your brother-in-law, but asset allocation can translate into more money for your retirement.

"Asset allocation is by far the most important thing that you can do," says Jerry Miccolis, a certified financial planner with Brinton Eaton Wealth Advisors in Morristown, N.J. "It

is more important than which mutual funds you invest in or what stocks you buy. Getting asset allocation right is 80 percent or 90 percent of the game."

These are typical asset categories:

Stocks have several subcategories according to size, price and other financial characteristics. These include value, growth, large-cap, mid-cap, small-cap, domestic, foreign and emerging markets. They can also be classified by sector, specific geographic regions and other variables. Generally, stocks offer the highest returns but carry the most risk.

Bonds, too, have specialized areas. They are characterized according to risk, issuer, maturity or geographic origin. These subcategories include investment grade, junk (high yield), government, mortgage-backed, corporate, short-term, intermediate, long-term, domestic, foreign and emerging markets bonds. Generally, bonds offer higher returns than cash equivalents, but carry more risk.

Cash is considered the safest form of investment, but offers the lowest return. Cash-equivalent investments are Treasury bills, money market funds, money market accounts, savings accounts, certificates of deposit, etc.

Real estate, as in real property, has its own market cycles and often performs in direct opposition to the stock market.

REITs are publicly traded stocks of companies that own and manage multiple income properties on behalf of their investors. They are traded like stocks, but are composed of real estate holdings, so they rise and fall in tandem with the real estate market.

The sophisticated may invest in more esoteric assets such as natural resources (timber, oil), precious metals (gold and silver) or luxury collectables (art, fine wine, coins, automobiles), but these often require special knowledge or expertise. We'll focus on mainstream asset categories.

Goals, time, risk tolerance

When deciding how to allocate your money, you should know your retirement goals, time horizon, how much you can annually save toward your goal and how much risk you are willing to assume. Risk tolerance is all about your ability and willingness to lose all or some of your initial investment in the expectation of a higher return.

Walt Woerheide, a certified financial planner and a professor of investments at the American College, says risk tolerance depends on the individual, but education can make a big difference. "People can tolerate risk better when they understand the nature of risk," he says. "For example, people who understand how a parachute opens and the mechanics are more willing to go sky diving than someone for whom it is kind of a mystery about how the chute will open up."

For that reason, it's a good idea to avail yourself of any educational opportunities your company may provide -- seminars, teleconferences, informative Web sites -- that can help you bone up on asset allocation.

All portfolios, however, should reflect the basic tenet for savers to "invest and stay well diversified," says Ellen Rinaldi, Vanguard's director of investment counseling and research.

Common mistakes

Not managing asset allocation wisely can cause you to delay retirement or reduce the amount you'll have to live on once you quit working. The most common mistake is being too conservative and not putting enough in stocks when you're young. "If you're overly conservative, you don't get the growth that you need," Charney says.

Taking on too much risk can also cause problems. Imagine this scenario: You're two years from retirement and you've got 90 percent of your portfolio in stocks. The stock market takes a sharp dive. Your nest egg shrinks accordingly and doesn't rebound in time for your retirement. You either take a big loss and risk outliving your savings or postpone retirement until the market rebounds.

Other mistakes include not saving enough to meet your goals or raiding your retirement funds to put your children through college, Charney says.

Young people, in particular, should keep in mind that their retirement goal is so far off that a steep dip in the stock market is not a grave matter, and the performance of the market over the long haul outweighs any short-term risk. As you get older, you can manage risk by selling stocks and investing a larger portion of your portfolio in bonds or cash.

You also don't want to be chasing returns. Too often investors fall into that trap. "You want to be patient and not jump in and out of investments," says Bard Malovany of Sagemark Consulting.

Instead of buying a fund with blazing performance over the past six months or year, look for the best long-term fund for each investment category. It's important to note five- or 10-year performance numbers, but also look at the annual returns and compare them with that of the relevant benchmark (for stocks, that's usually the Standard & Poor's 500) to see if performance is erratic or fairly consistent. "You're not trying to find the best performer of all time. Instead, you're looking for the one that performs best compared with other funds in the same class," says Malovany.

Be sure you understand the composition of a particular fund before buying in. Don't just go by its name. A "balanced" fund may sound perfect, but you may find it is too conservative for your needs, Vanguard's Rinaldi says. Typically, balanced funds are split

between equities, at 60 percent of assets, and bonds, at 40 percent, she says. Someone in their 20s needs a fund that is much more heavily weighted toward stocks. Even those in their early 40s should have around 90 percent invested in equities, she says. "You still have at least a 25-year run until retirement."

Also, if your company's contribution to retirement savings includes company stock, be sure it makes up no more than 10 percent of your portfolio, Rinaldi cautions. If it passes that 10 percent threshold, sell off some and invest the money elsewhere to ensure diversification.

All-terrain vehicles

Lifecycle or target funds are one-stop shopping vehicles that do the asset allocation work for you. Fund managers adjust their composition to a more conservative stance as the target date to retirement draws near. "It's the difference between having a manual transmission, where you have to do the work yourself, or an automatic," says T. Rowe Price's Ritter.

You can identify the one for you by matching your retirement date with that of the fund, such as Retirement Fund 2015.

If you're a do-it-yourself type of investor, you can diversify by allocating your assets among the various types of investments within each category. For example, the money you plan to invest in stocks shouldn't go into a particular type, such as high-tech, small-cap or even large-cap, but rather a mix of these and others. Diversifying in this way further reduces risk and maximizes returns.

Be careful, though, that you don't buy two funds with essentially the same stocks. To avoid overlap, check the sectors represented in the funds to make sure your investments are truly diversified.

Rebalancing your portfolio

Once you've determined your asset allocation, you'll want to maintain that allocation for a while. Periodically adjust your portfolio so the percentages remain constant.

Typically, your 401(k) will get thrown out of balance over time as some investments grow faster than others. For example, say you started out with 60 percent in stocks. The past year has been a roaring bull market. Now your stocks make up 80 percent of your portfolio while bonds are down to 20 percent. You should rebalance by selling stocks and buying bonds so your portfolio is back in synch. That's a successful investing technique called buying low and selling high.

It's easier said than done because it's counterintuitive. You're selling off what's done well and buying up what's been underperforming.

"It just doesn't feel right," says Matthew Tuttle, a certified financial planner and president of Tuttle Wealth Management in Stamford, Conn. Simply because it doesn't feel right doesn't mean it's wrong.

Rebalancing your retirement savings once a year should be sufficient. Time it to the New Year, your birthday or Bastille Day -- whatever day works best for you.

Asset allocation is the single most important determinant of portfolio returns, say financial analysts. Paying attention to this investment approach will go a long way toward ensuring a comfortable retirement.