INVESTING: MAKING YOUR DOLLARS WORK FOR YOU

OPTIMUM ASSET ALLOCATION

Considering how many mutual funds, stocks, and bonds are available, it's not surprising that you might be confused about how to put together the right mix of investments.

But determining the proper asset allocation is relatively simple; you really only need to consider a few things.

We're going to look at what you need to know to allocate your assets like a pro.

WHAT EXACTLY IS ASSET ALLOCATION?

Asset allocation is a technique used in portfolio management to create diversification and balance risk.

Diversification is accomplished by separating the investor's assets among different categories of investments; these could include such things as stocks, bonds, mutual funds, cash, real estate, and derivatives.

Each category of investment carries its own level of return and risk, which results in each type of investment behaving differently over time. While one type of asset is decreasing in value, another is likely to be increasing. By the same mechanism, when one investment is doing well, another is likely to be losing value.

Some experts argue that this type of diversification (and all diversification in general) is a guarantee of mediocrity. But for the average investor, ***this is the best way to ensure that no catastrophic losses are experienced.***

Most experts agree that thoughtful asset allocation is among the most relevant decisions that any investor can make. Or said another way, the actual stocks or bonds that you choose comes in second place to the way in which you choose to allocate your assets among the various investment categories.

There is no one-size-fits-all formula that will find the best asset allocation for every investor.

However, it's wise to consider these five important items when determining the proper asset allocation for your personal circumstances:

1.Risk vs. potential return. The trade-off between risk and reward is really what asset allocation is all about. While everyone wants the greatest return possible, it's easy to have several derivative investments fail to produce a return. Stocks aren't always the answer either.

- The stock market crashes of the past are good examples of how risky stocks can be in the short-term. Clearly, investing solely in those stocks with the highest potential for big returns has not been the best strategy.

- That is not to say that more risk tolerant investors should have a greater allocation of their portfolio in stocks compared to more conservative investors. But successful investors consider risk and return and position themselves in a place that feels comfortable to them along the continuum.

- ***Keep in mind that bonds are not necessarily less risky than stocks.*** There are stocks that are extremely safe, though the opportunity for growth is minimal. As well, there are bonds with very low credit ratings that can pay very high returns but are extremely risky (likely to default and not pay).

- ***In a nutshell:***

    - **Stocks:** Among the 3 major asset categories, stocks have traditionally had the highest rates of return and the greatest amount of risk. Even the stocks of large companies can be quite volatile in the short-term and lose money on an average of 1 year out of every 3. Even so, in the long-term, stocks have always been the clear winner when it comes to returns.

        - As you get closer to a financial goal, it makes good sense to start moving money from stocks into bonds. This is because the certainty of having the money available becomes more important than the potential for growth.

- **Bonds:** Bonds are usually less volatile than stocks but typically provide a lower rate of return as well.

    - Remember that bonds with low credit ratings can give stock-like performance, but they can be very risky investments.

- **Cash/Cash equivalents:** These are super-safe investments; some of them are even insured. When you're going to need your money soon, this is the place to put it.

2. Avoid blindly using numbers from a planner sheet or software program. While the survey sheets that are put out by financial advisors can be a good starting point, every situation is unique. The same goes for recommendations given by any of the many financial software packages.

- The numbers that are given from these sources of information are largely developed based on the age of the investor. However, these suggestions frequently do not take into account things like how many children you have, or if you have any children at all.

    Your plan needs to be developed around your own situation and goals.

- Standardized plans are frequently pushed on investors because it's easier on the firm pushing the plan; they don't have to spend as much time on you.

3. Define your short-term and long-term goals. Everyone's goals are different. Some of us would be grateful to retire into a lower to middle class lifestyle when we're 70 years old; others are trying to retire with 3 homes and yacht by age 55. Some are simply trying to save up to purchase a car.

- If you're planning for retirement with a 30-year time horizon, short-term stock market fluctuations are going to be less of a concern than they are for someone planning to put 2 teenagers into college in the next 3 years. The latter will probably favor safer varieties of fixed-income investments.

- Consider what your financial needs will be by looking forward in 5-year intervals. Take into account your children, spouse, health, your current income, and your level of debt.

4. Allocate your assets accordingly. If your time horizon is:

- **Less than 1 year:** Assets should largely be in cash and cash equivalents; this would include things like short-term certificates of deposit, money market accounts, savings accounts, and treasury bills.

- **1 - 5 years:** Fixed income securities, like bonds, make more sense at this time frame. You won't need the money immediately, but you still don't have the time cushion to absorb any significant stock market setbacks; any stocks you purchase should be in very stable companies.

- If you're at the shorter end of this time frame; a portion of your money kept in cash/cash equivalents is smart.

- **5 - 10 years:** A mixture of safer stocks and bonds is where you want to be. Your plan here will largely be a function of your tolerance for risk.

- **10 years +:** With this much time, you can afford to be bolder and take on greater risk. There should be enough time to recover from any stock market blips. More aggressive stock investments can be used in this situation. You can even get into derivatives if you feel comfortable with your level of expertise and have the stomach for it.

Asset allocation is not complicated, but it does require some thought. Consider where you are right now financially and where you would like to finish.

Knowing your goals and timeframe are the two most important factors. Your tolerance for risk allows you to fine tune your asset allocation.

Asset allocation is important for every investor; ensure your portfolio meets your needs!