

Asset Allocation: A Key to Portfolio Success

For many investors, investing typically begins with one stock or mutual fund. Over time, other selections are added because many people understand it may not be prudent to invest everything in a single security, even if it has a “blue chip” reputation. However, just “spreading money around” in a haphazard way may create only an illusion of diversification.

If you have assembled a “hodgepodge” portfolio, you may not know the extent to which your investments are (or are not) consistent with your objectives. How do you go about setting up a framework which tailors your investments to your particular circumstances?

A sound portfolio management strategy begins with asset allocation – that is, dividing your investments among the major asset categories of equities, bonds and cash. Since each type of investment category has unique characteristics, they rarely rise or fall at the same time. Then, you can make finer distinctions within each asset category (i.e., diversification). Combining different asset classes could help reduce risk, although it doesn't eliminate market risk altogether. Still two nagging questions remain: What factors guide the asset allocation process? How much of a portfolio should go into each category.

To answer the first question, the main objective of asset allocation is to match the investment characteristics of the various investment categories to the most important aspects of your personal investment profile – that is, your tolerance for risk, your return and liquidity needs, and your time horizon.

Investing according to your risk tolerance will help keep you from abandoning your investment program during times of market turbulence. One way to measure your risk comfort zone is to ask yourself how much of a loss in a one-year period you could withstand and still stay the course.

Finding an appropriate match for you means balancing your tolerance for risk against the different volatility levels of various asset classes. For example, if you have a low tolerance for risk, that fact may dictate a portfolio that emphasizes conservative investments while sacrificing the potentially higher returns that usually involve a greater degree of risk.

Return need refers to the income and/or growth you expect a portfolio to generate in order to meet your objectives. For example, retirees may prefer a portfolio that emphasizes current income, while younger investors may wish to concentrate on potential growth.

Your personal time horizon extends from when you implement an investment strategy until you need to begin withdrawing money from a portfolio. For example, a very short time horizon (less than 5 years) is probably best served by a conservative portfolio emphasizing safety of principal. On the other hand, the more time you have to invest, the greater risk you may be able to withstand because you have time to recover from market downturns.

The short answer to how much of a portfolio should go into each category is that asset allocation is more a personal process than a strategy based on a set formula. There are guidelines to help establish the general framework of a well-diversified portfolio. For example, you may decide on the need for growth in order to offset the erosion of purchasing power caused by inflation.

However, building an investment portfolio that is right for you involves matching the risk-return tradeoffs of various asset classes to your unique investment profile. One final point that is worthy of emphasis – when you put together your own asset allocation strategy, you should combine all your assets (i.e., your investments and retirement savings). That way you can ensure that all your assets are working together to help meet your goals and objectives. Keep in mind, investment return and principal value will fluctuate with changes in market conditions so that shares may be more or less than original cost. Diversification cannot eliminate the risk of investment losses.

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