Asset Allocation

A Key to Portfolio Success

For many people, investing typically begins with one stock or one bond or one mutual fund. Over time, other selections are added to manage the risk associated with investing everything in a single security. However, just “spreading money around” in a haphazard way may create only an *illusion* of **diversification**.

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

Plotting Your Course

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 investment category has unique characteristics, they rarely rise or fall at the same time. Within each asset category you can make finer distinctions (i.e., **diversify**). Combining different asset classes can help reduce risk and improve the overall return of a portfolio. Still, two nagging questions remain: What factors guide the asset allocation process? How much of a portfolio should go into each category?

Getting to Know You. . .

To answer the first question, *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 plan during times of market turbulence. For example, if you have a low tolerance for risk, you may emphasize conservative investments over those that offer potentially higher returns, but may involve a greater degree of risk.

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Return 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 short time horizon (less than five years) is probably best served by a conservative portfolio emphasizing the protection 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.

Your Final Destination

Asset allocation is more a *personal* process than a strategy based on a set formula. However, 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.

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: You should consider *all* your assets when you put together your own asset allocation strategy—this includes your investments and retirement savings. Doing so can help ensure that all your assets are working in accord to meet your goals and objectives.

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