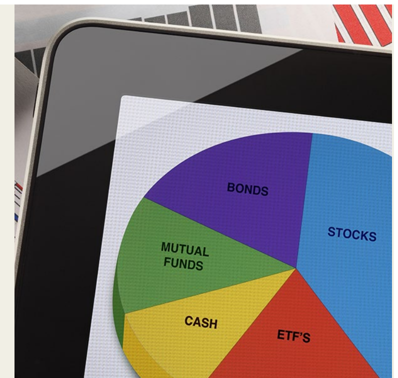
Financial Planning

How Asset Allocation Can Benefit You, the Investor

A Portfolio Approach

Investing 101 teaches us to remember that no single investment should be viewed alone. We often use the term “Big Picture” to describe events and situations in our lives and this is a very relevant term when considering our investments. All decisions regarding your investments should be made using the Portfolio, or Big Picture, approach.



Our starting point should always be asset allocation as this will help us to prudently diversify our investments. Asset allocation is the process through which we divide our portfolio into broad asset classes such as cash and equivalents, fixed income instruments and equities. Then, depending on our unique circumstances, we further divide these asset classes into styles and market capitalization. Why we do that and how it can be accomplished are the canvas on which your Big Picture will be painted.

Pinpointing Your Specific Investment Scenario

As you begin, you need to ask yourself a few questions. What are your investment objectives? Are you seeking growth, income or a combination? Investment objectives can change over time, so it is important to think of your long-term goals and how to achieve them while keeping an eye on needs that you may want to fill from your portfolio in the interim. Two important variables to address are your time horizon and risk tolerance.

Determining your time horizon will tell you the number of years you have to achieve your financial goals. Asset classes can perform differently during various stages of economic cycles and often these cycles take many years to play out. Risk tolerance in its most dramatic form is how willing you are to lose the principal in your portfolios while you are seeking greater potential returns. If the time to achieve your investment objectives is relatively short, for example if retirement is just around the corner, then you may be willing to assume less risk in order to help retain as much of your principal as possible and this would define a more conservative investor. If you do not expect to have any intermediate needs for the funds in your portfolio and you believe your investments can go through many phases of the economy and you can tolerate

the potential volatility, then you may be willing to assume more risk in exchange for the possibility of higher long-term returns and you may consider yourself to be a more aggressive investor. A more middle-of-the-road approach could be considered for a moderate risk investor, one who is willing to assume some risk in exchange for the potential for a moderate amount of long-term return. One must keep in mind, however, that all investments incur risk and there is no guarantee that some or all of your investments could not be lost.

Diversification

A combination of asset classes can help mitigate risk in your portfolio as shown when we look at longer term returns for the different asset classes. Historically, the returns for the three major asset classes (cash and equivalents, bonds and stocks) have not moved up and down at the same time, although the correlation may be more difficult to determine over shorter periods of time. When you combine asset classes, you have taken the first step to building diversification in your portfolio. In its purest form, the goal is to have a mix of investments so that if some go down in value, others will increase to help offset these declines and perhaps even produce some gains. But in order to prudently diversify a portfolio, you do not stop here.

Diversification in its most useful form requires us to look at the investments within the broad asset classes. For example, when building the bond component, we need to consider whether corporates, governments or municipals are the most suitable. An account's taxability comes into play when making these decisions as some investments are more appropriate for taxable versus tax-deferred accounts. An examination of geographic and industry diversification, bond ratings, yields and maturities and choosing those suitable for your risk tolerance are also key to building diversification within this asset class.

Diversifying within the equity sector can involve even more variables. Diversification models are essential to provide this guidance. These models take into account your risk orientation, your income needs and the growth potential you are seeking from your investments. Again, investing for the long term requires an appropriate mix of investments. Within the equity sector, this includes style (growth, value or a blend) and market capitalization (large, mid and small-cap). Growth stocks versus value stocks take into account growth rates for earnings, sales, book value, cash flow and dividend yields. Small cap stocks can have a market capitalization below $1 billion whereas large caps can be above $8 billion. Further diversification can be achieved by ensuring you have representation across the sectors in your equity investments. Your Financial Advisor can discuss with you current sector guidance and whether there is sufficient representation across sectors. Sectors can have a number of sub-groups so it is important to spread your investment dollars across these groups.

There are two Benjamin F. Edwards reports, The Importance of Diversification and Strategic Asset Allocation Models which can help you in your quest to prudently diversify your portfolio. Included in these reports are suggestions for asset class and style, depending upon your particular investment objective and risk orientation.

Rebalancing

You may think that once you have determined an appropriate asset allocation based on the variables discussed above that you are finished. This could not be further from the truth. Asset allocation is a process; it has no end.

Your personal circumstances and needs, the domestic and global economies and market conditions do not stop. They are ever-changing and evolving and so must also be the way you view your investments. While a major life event such as nearing retirement may evoke the need to make changes in your portfolio, rebalancing on a periodic basis can help you to be sure your portfolio is in concert with your investment profile. Market movement can change the relative valuations of your holdings such that your asset class and style percentages no longer meet your goals. The mechanics of rebalancing can include reducing and selling investments in over-weighted areas to free up funds to make purchases in under-represented areas or adding new money to the portfolio. Of course, all rebalancing decisions must take into consideration tax ramifications.

Your financial advisor has the tools to help you with any or all of the investment decisions you need to make. All investments, both existing and new must be evaluated using the portfolio approach. After all, portfolio is a collective rather than an individual term. ■

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