Asset Allocation Explained

Most of us attempt to save money. We know there will come a time when what we save today will be needed to pay for things tomorrow.

Our choices about how to do this are varied, mysterious, and confusing. Too often we take the easiest path and hope for the best. We congratulate ourselves for at least doing something.

When it comes to retirement, which is often a 30-year trek into an unknown future, doing a little and hoping for the best is usually a recipe for failure and disappointment.

What follows is an attempt to wipe away some of the confusion when it comes to investing money in an attempt to make it grow. Think of it as a recipe ingredient to avoid a tasteless and frustrating future for you and your family.

The term **asset allocation** is the allocation of money across assets in a portfolio that differ from each other in statistically important ways.

It's derived from Modern Portfolio Theory (MPT). This is an established discipline taught at business schools across the country. The focus is to reduce risk by using the asset classes available to investors. MPT assumes that investors prefer to invest their money in portfolios that (1) offer **less risk** to achieve a given rate of return or, (2) provide a **higher rate of return** at the same level of risk.

The importance of asset allocation has been demonstrated by numerous studies. The most famous is based on the study done by Gary P. Brinson, Randolph L. Hood and Gilbert L. Beebower, *"Determinants of Portfolio Performance II*", published in the Financial Analysts Journal, January/February 1995. Their assertion shows asset allocation accounts for more than 90% of a portfolio's performance. Other forces like market timing and individual investment selection account for only 1.7% and 2.5% of a portfolio's long term performance, respectively.

The objective is to use sophisticated statistical information to create a road map for achieving financial success. Used by money managers, financial planners and investors, the road map, or asset allocation model, can be defined as **the best mixture of investments necessary to achieve a specific goal.** Creating an effective mixture requires a substantial base of research used to develop statistical and mathematical tools for quantifying risk and reward in investment portfolios.

The first step is to understand the distinction between asset categories and assets in general. Asset categories are such things as stocks, bonds, real estate and cash. However, the effective use of MPT requires asset categories be broken down much further, identifying hundreds of asset categories. For example, stocks might appear as domestic or foreign, large medium and small, to name a few.
Another study, done decades ago and also published in the Financial Analysts Journal, revealed that over 93% of a portfolio's performance results from decisions made by the client and the investment advisor with respect to which asset categories were chosen and their relative weighting.

In other words, the selection of asset categories to include, and how much to give to these categories respectively, will account for 93% of the overall performance of the portfolio. The remaining 7% can be attributed to timing and the individual security chosen. **From this we can conclude that most of our time should be spent choosing between asset categories and not between specific securities.**

No asset allocation plan can be complete without taking into account client preferences and existing portfolio limitations. How much risk or volatility do you want to live with over time to achieve your objectives? How much risk are you willing to accept? Does your current age have anything to do with your willingness to accept risk?

In the context of planning for retirement, what is your time horizon? The rest of your life? If so, how long are you likely to live? Annual reviews using updated historical investment performance data will assure the objectives and results are monitored and changes made as necessary.

There are, therefore, two key determinants in achieving investment success. They are the **asset categories** chosen, and **time**. The longer the particular portfolio is held, the lower the amount of overall fluctuation and the better the results. The investor must accept, however, that an asset allocation plan does not guarantee results. It is simply a way to quantify some of the many variables faced by an investor and by so doing, minimize the effects of guesswork and intuition.

In summary, it's apparent to that it's more important for an investor to know **HOW** and WHY to invest his or her money than to know in **WHAT** to invest his or her money. That's what I attempt to teach at Successful Retirement Secrets.

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