Understanding Your Asset Allocation

Asset allocation is a common strategy that you can use to construct an investment portfolio. Asset allocation isn't about picking individual securities. Instead, you focus on broad categories of investments, mixing them together in the right proportion to match your financial goals, the amount of time you have to invest, and your tolerance for risk.

The Basics of Asset Allocation

The idea behind asset allocation is that because not all investments are alike, you can balance risk and return in your portfolio by spreading your investment dollars among different types of assets, such as stocks, bonds, and cash alternatives. It doesn't guarantee a profit or ensure against a loss, of course, but it can help you manage the level and type of risk you face.

Different types of assets carry different levels of risk and potential for return, and typically don't respond to market forces in the same way at the same time. For instance, when the return of one asset type is declining, the return of another may be growing (though there are no guarantees). If you diversify by owning a variety of assets, a downturn in a single holding won't necessarily spell disaster for your entire portfolio.

Using asset allocation, you identify the asset classes that are appropriate for you and decide the percentage of your investment dollars that should be allocated to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives).

The Three Major Classes of Assets

Here's a look at the three major classes of assets you'll generally be considering when you use asset allocation.

Stocks: Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return than other investments, including bonds and cash alternatives. However, stocks are generally more volatile than bonds or cash alternatives. Investing in stocks may be appropriate if your investment goals are long-term.

Bonds: Historically less volatile than stocks, bonds do not provide as much opportunity for growth as stocks do. They are sensitive to interest rate changes; when interest rates rise, bond values tend to fall, and when interest rates fall, bond values tend to rise. As a result, bonds redeemed prior to maturity may be worth more or less than their original cost. Because bonds typically offer fixed interest payments at regular intervals, they may be appropriate if you want regular income from your investments.

Cash alternatives: Cash alternatives (or short-term instruments) offer a lower potential for growth than other types of assets but are the least volatile. They are subject to inflation risk, the chance that returns won't outpace rising prices. They provide easier access to funds than longer-term investments, and may be appropriate for investment goals that are short-term.

Not only can you diversify across asset classes by purchasing stocks, bonds, and cash alternatives, you can also diversify within a single asset class. For example, when investing in stocks, you can choose to invest in large companies that tend to be less risky than small companies. Or, you could choose to divide your investment dollars according to investment style, investing for growth or for value. Though the investment possibilities are limitless, your objective is always the same: to diversify by choosing complementary investments that balance risk and reward within your portfolio.

Decide How to Divide Your Assets

Your objective in using asset allocation is to construct a portfolio that can provide you with the return on your investment you want without exposing you to more risk than you feel comfortable with. How long you have to invest is important, too, because the longer you have to invest, the more time you have to ride out market ups and downs.

When you're trying to construct a portfolio, you can use worksheets or interactive tools that help identify your investment objectives, your risk tolerance level, and your investment time horizon. These tools may also suggest model or sample allocations that strike a balance between risk and return, based on the information you provide.

For instance, if your investment goal is to save for your retirement over the next 20 years and you can tolerate a relatively high degree of market volatility, a model allocation might suggest that you put a large percentage of your investment dollars in stocks, and allocate a smaller percentage to bonds and cash alternatives. Of course, models are intended to serve only as general guides; determining the right allocation for your individual circumstances may require more sophisticated analysis.

Build Your Portfolio

The next step is to choose specific investments for your portfolio that match your asset allocation strategy. Investors who are investing through a workplace retirement savings plan typically invest through mutual funds; a diversified portfolio of individual securities is easier to assemble in a separate account.

Mutual funds offer instant diversification within an asset class, and in many cases, the benefits of professional money management. Investments in each fund are chosen according to a specific objective, making it easier to identify a fund or a group of funds that meet your needs. For instance, some of the common terms you'll see used to describe fund objectives are capital preservation, income (or current income), income and growth (or balanced), growth, and aggressive growth. As with any investment in a mutual fund, you should consider your time frame, risk tolerance, and investing objectives.

Note: *Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing.*

Pay Attention to Your Portfolio

Once you've chosen your initial allocation, revisit your portfolio at least once a year (or more often if markets are experiencing greater short-term fluctuations). One reason to do this is to rebalance your portfolio. Because of market fluctuations, your portfolio may no longer reflect the initial allocation balance you chose. For instance, if the stock market has been performing well, eventually you'll end up with a higher percentage of your investment dollars in stocks than you initially intended. To rebalance, you may want to shift funds from one asset class to another.

In some cases you may want to rethink your entire allocation strategy. If you're no longer comfortable with the same level of risk, your financial goals have changed, or you're getting close to the time when you'll need the money, you may need to change your asset mix.

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