

[Home](#) > [News & Opinion](#) > [Business News](#) >

Asset allocation translates into prudent investing

By **Pran N. Tiku**/ Daily News Correspondent
Monday, May 8, 2006

Asset allocation is one of the catch phrases of investing that typically grabs the attention of investors and the media when the stock markets are struggling.

Given that recent stock market performance has been somewhat impressive, the concept of asset allocation has receded into the background. So is there anything to worry about? I say yes!

For one, it is highly unlikely that the recent gains achieved by the stock market will continue indefinitely. In the future as in the past, markets will zig and zag and sputter or even dive. For investors who are not paying attention, such events can cause a jolt of electricity and make a mockery of their retirement plans, education funding or other financial objectives near and dear to them.

These are some of the reasons why you, as an investor, need to know and practice asset allocation. After all, the investing landscape is littered with the skeletons of yesteryear such as recessions, the dot-com bust, the 9/11 disaster, fraudulent undertakings by Enron and WorldCom, etc.

Asset allocation in simple non-technical jargon means dividing (allocating) your portfolio among distinct investments, also known as asset classes, which are sufficiently different from each other to behave differently in different investing environments. So what does that actually mean? Let's take a simple example such as stocks vs. bonds vs. cash. These are three different investments or asset classes, and are expected to behave differently under different market conditions.

As an illustration, say the economy is growing at a reasonable rate and it is expected that the earnings of companies are likely to go up as a result. This is more than likely going to push the companies' stock prices higher. However, the economy or company earnings may have very little influence on U.S. bond prices, particularly government bonds.

On the other hand, it is quite logical to assume that the opposite will be the case if the economy falters and the earnings of companies take a dive, the stock prices of the companies may suffer. Here again there may be very little impact on bonds. In this particular case, we say that stock performance is not correlated with bond performance.

The theory of asset allocation states that the overall portfolio should be constructed with investments that are not correlated to each other to the extent that it practical or feasible.

Combining different asset classes such as stocks and bonds is likely to reduce the portfolio's risk and provide an upside depending on market conditions. Concentrating a portfolio into only stocks or bonds may have the effect of either increasing risk or reducing performance.

Unfortunately, asset allocation is not a one-size-fits-all formula that will work for all in all circumstances. Asset

allocation is specific and based on an individual's goals, preferences and constraints.

For example, the asset allocation for a person age 30 who is accumulating money for retirement decades away has to be different than for someone age 67 who is retired and using her portfolio to supplement her pension or social security income.

In the first case, the allocation may call for close to 100 percent stocks or other equity investments to achieve future growth. In the case of the retiree, the asset allocation may call for a portfolio of mostly Cash, CDs or government bonds to generate steady income with a small measure of stock or equity investments to protect the future purchasing power.

Most studies show that asset allocation, rather than the picking of a stock or a mutual fund, is the most critical decision in building a durable long-term portfolio and is likely to have the most impact on the portfolio's performance.

The simple examples of asset allocation to stocks, bonds and cash cited above are somewhat obvious and are in sync with the basic commonsense approach to investing. But life is not always that simple or that obvious and the options in asset allocation can be somewhat complex.

As the global economy takes hold and investment opportunities around the world become available to most investors, the plate gets full of complicated choices. For investors focused on doing well while controlling risk, asset allocation using multiple asset classes becomes important.

Today's investor can easily create a portfolio that could include virtually any asset class. Domestic stocks can be divided into growth or value styles and separated by market cap: large, medium, small and micro. International stocks are mostly comprised of developed countries such as Western Europe and Japan but extend to emerging or developing markets such as Brazil, Malaysia, Korea, South Africa, Russia and China with or without Hong Kong.

Most of these investments are available in stocks, bonds and different currencies. You could also buy commodities from wheat to gold or other precious metals. The point remains that these investments often behave very differently from each other. Exposure to many of these asset classes in a portfolio is likely to enhance the return and reduce risk, which should be the goal of any portfolio.

So today's investors not only needs to know their goals, time horizon and tax implications, but also how to construct a portfolio of diverse investments from across the world to develop an asset allocation to achieve growth or income and smooth out some of the ups and downs of the financial markets.

Pran N. Tiku, CFP, is a financial adviser with Peak Financial Management, a fee-only wealth management firm in Waltham. He can be reached at Pran@peak-financial.com.