

# INVESTMENT PLAN

## The Impact of Asset Allocation

[by Larry Fiorini]

While many investors spend their time on individual security selection, history has shown that asset allocation is the biggest factor in long-term performance. In most cases, it is the key determinant of your portfolio's rate of return over time.

Several studies have concluded that market timing and individual asset selection account for only 6 percent of the variation in returns, with strategy or asset class selection determining up to 94 percent of future returns.

Unfortunately, most people don't devote nearly enough time to the asset allocation decision. They become bogged down with stock picking and trading activities that are time consuming and overwhelming. It is generally more beneficial and less resource-intensive to take a broader view and concentrate on individual asset classes. Most investors will find the process simplified and ultimately more profitable.

Generally, determining the appropriate allocation is a personal decision. Knowing your risk tolerance helps you calculate probable investment returns and choose which allocation fits into your portfolio.

### Understanding asset allocation

Let's examine exactly what asset allocation is and what it can mean to a portfolio. Finance textbooks define it as the process of dividing a portfolio among different asset classes—such as stocks, bonds, real estate, and cash—to achieve the appropriate risk/reward trade-off based on an individual's current situation and future goals. Typical investors might say asset allocation is the way you divide your investments among different securities or mutual funds, feeling that

because they own several mutual funds, they are achieving asset allocation.

The danger in this thinking is that all too often investors own numerous funds that all own the same securities and actually offer minimal or no diversification. The reason investors diversify is to minimize risk. Statistically, you want to invest in asset classes whose returns have a low correlation with the returns on other securities in your portfolio.

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### Asset Class Performance: 1926–2005

Source: 2006 Ibbotson Associates, Inc.

		Small stocks	Large stocks	Government bonds	Treasury bills
Annual	Compound annual return	12.6%	10.4%	5.5%	3.7%
	Standard deviation	32.9%	20.2%	9.2%	3.1%
12-month rolling periods	Highest return	316.4%	162.9%	54.4%	15.2%
	Lowest return	-75.9%	-67.6%	-17.1%	0.0%
	Average positive return	31.9%	22.0%	8.6%	3.8%
	Average negative return	-18.6%	-13.7%	-3.5%	0.0%
	Percent periods positive	72.4%	73.9%	77.8%	98.3%
	Percent periods negative	27.6%	26.1%	22.2%	1.7%

Assumes reinvestment of income and no transaction costs or taxes.

This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. 3/1/2006

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### **The components of diversification**

To achieve an ideal asset allocation, you need to understand the components of diversification. It comes in two layers: diversification across assets, which is how much money to hold in stocks, bonds, and other asset classes; and diversification within assets, which spreads your dollars within asset groups, such as stocks (large, small, midsized, and international) and bonds (short-term, long-term, corporate, and tax-exempt). The chart on page 20 illustrates how different asset classes have performed over the past 20 years and the level of risk they take as measured by standard deviation.

### **What's your goal?**

The first step in developing an appropriate investment strategy and asset allocation is to understand your circumstances. Why are you investing your money? Is it to save for retirement, a child's education, a house, a vacation, or all of the above? If you're saving for retirement, your time horizon may span several decades. With time on your side, you can place a greater emphasis on stocks, which historically have achieved the highest long-term returns along with the widest short-term price swings. By contrast, if you're investing for a short-term goal, such as a vacation, a less volatile investment, such as a money market fund, is sensible, because you would have little time to recoup any investment losses from a market downturn. The longer your time frame, the greater your ability to absorb the ups and downs of the market.

### **Rebalancing**

Over time, your asset allocation could diverge from your ideal allocation as a result of price changes. I suggest periodic rebalancing of portfolios to maintain a desired allocation level; rebalancing brings your allocation back to your model.

For example, assume that your optimal asset allocation is 60 percent stocks and 40 percent bonds. Over time, your equity allocation has grown to 70 percent. A few percentage points over a particular allocation may not mandate drastic rebalancing.

However, if your asset allocations are off by 10 percent or more, you should consider rebalancing. To maximize tax efficiency, rebalance your most tax-friendly accounts first, such as individual retirement accounts (IRAs) and 401(k)s.

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### **Make the correct decision**

This brings us to the toughest question: what is the proper asset allocation? Generally, determining the appropriate allocation is a personal decision. Knowing your risk tolerance helps you calculate probable investment returns and choose which allocation fits into your portfolio. But many investors don't know their risk tolerance, and without this knowledge, it is extremely difficult to ascertain the correct asset allocation. I would recommend starting by completing a risk identification form. Many financial Web sites offer risk questionnaires, and in most cases, you can get them through your company's 401(k) site, mutual fund site, or you can contact one of the financial advisors at LarsonAllen Financial. Give yourself the best chance to achieve your long-term goals by taking the time to start your investment program the right way. ●

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