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INVESTING

Asset allocation in hard times

By Dana Dratch • Bankrate.com

If you've ever worried: "Where is my investment money going?" then you've thought about asset allocation.

Fear that you might have too many similar stocks or too much money in bonds? Asset allocation. Debated the value of certain investment types, like small caps versus large caps, or stocks versus bonds for your long-term strategy? Asset allocation again.

Asset allocation is just technical jargon for how you've spread your money among different types of investments. Planners often look at it in terms of fractions or percentages of your total investment portfolio, such as 75 percent stocks and 25 percent bonds.

"What we find is that people don't really understand what asset allocation means," says Mark Berg, CFP, national board member of the National Association of Personal Financial Planners and the president of Wheaton, Ill.-based Timothy Financial Counsel Inc.

Too many times, investors believe it refers to the number of investments or funds they use, rather than the types of assets they are buying.

"Asset allocation is more important than ever before"

For example: An investor saving for retirement splits his 401(k) money between five different stock funds. But each fund focuses on Fortune 500 stocks. That means his asset allocation is not only 100 percent in stocks but 100 percent in the same type of stock -- large companies (or large caps). As a result, his retirement comfort rests solely on whether that portion of the market goes up or down.

Definitions

- **Asset allocation** -- An investing strategy that tries to minimize risk and maximize returns by putting money into different investment instruments.
- **Commodity** -- A physical substance, such as food, grains, and metals, which investors purchase, usually through what are called futures contracts.
- **Emerging market fund** -- A mutual fund or exchange-traded fund that invests in less developed countries with high growth potential.
- **Growth stocks** -- Companies with high levels of expected growth.
- **Value stocks** -- Stocks that are not current investor favorites, which may have a price/earnings ratio lower than the S&P 500.

See the Guide's Glossary for a further explanation of these terms.

Financial planners instead recommend spreading investments between a number of asset types (often called "asset classes"). A few of the asset classes you might see: small-cap, midcap and large-cap stocks; domestic and international stocks (international stocks will also distinguish between developed and emerging market stocks); value stocks; growth stocks; short-, intermediate- and long-term bonds (which include Treasury bonds, corporate bonds; municipal bonds and CDs); real estate and commodities.

"Asset allocation is more important than ever before," says Kathleen Miller, CFP, president of Miller Advisors Inc. in Kirkland, Wash. "What it's saying is that we know not all investments go up at the same time."

Finding the right mix of different assets can give you the diversity to protect your money for the long haul through any market, she says.

You need a plan

Asset allocation is the key to successful long-term investing.

"You have to have a plan in the first place, and that plan should anticipate these bear markets," says Larry Swedroe, author of "Wise Investing Made Simple," and principal with St. Louis-based Buckingham Asset Management.

A plan will keep you from reacting out of fear. "It gives you a road map for staying on track," says Karen Altfest, CFP, vice president of L.J. Altfest & Co., a New York-based fee-only financial planning firm.

"Any time you get into periods of high volatility, people get upset," says Peggy Cabaniss, CFP, president of HC Financial Advisors in Lafayette, Calif., and past national board chair for the National Association of Personal Financial Planners. "You need to plan ahead and pick an allocation you're comfortable with."

That way, she says, "you've sort of bulletproofed your portfolio."

To keep up with your money and reach your goal, you also want to have a succession of plans, not just one, over the course of your investing life. Beware of the one-size-fits-all solution.

"There is no perfect portfolio," says Swedroe. "There's only the perfect portfolio based on your ability, willingness and need."

Several different planners could recommend different allocation plans to the same client. Two clients who looked roughly the same on paper could select vastly different investment plans (one reason many financial planners caution consumers to use online asset allocation plan calculators as an information or research tool, not as a one-stop source.)

"No two clients are alike," says Berg. One of his clients is a 40-something who is an inveterate saver. But her tolerance for risk is low. "So we have her portfolio in a 50/50 mix" of stocks and bonds, he says. While that wouldn't be his solution for everyone, he says, "She's willing to save longer and take less risk."

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Where to start

You and your financial planner will first look at several things. What is your goal and when do you want this money available? If you're retiring in 30 years, the plan could look much different than if you're retiring in the next decade.

Once you know your goal and timeline, "the rest of the pieces fall into place," says Berg.

Next, what is your risk tolerance? Usually, you balance this with your need to keep pace with inflation and come up with a mix that will keep your money growing and let you sleep at night.

The secret: "Not taking more risk than you have the ability, willingness or need to take," says Swedroe.

Some other factors you'll consider:

- What's your household income and how much money will you be investing?
- What are your needs and additional resources? If you're saving for retirement, will you also have a pension? Will you still have mortgage payments? Will you start a business or work part-time? Or would you rather read and travel?

But you have to be really honest with yourself. "A lot of people think they can tolerate higher risk," says Cabaniss. "But 99.9 percent of people cannot take high volatility and cannot take unsettling news."

Look for your risk tolerance to change over time, as your salary increases, as your life changes and as you get more experience as an investor. If you're half of a couple, the more difficult task is to factor in the risk tolerance of both parties.

Based on the information, you and the planner will decide what percentage of your investment money should go into certain asset classes. Ideally, "you want things that when one is doing not so well, the others are doing great," says Swedroe.

Then you can select investment vehicles that match the plan you've drafted.

For most individual investors, that will probably be mutual funds (like index funds) that have a wide variety of investments in that asset class. For instance, if you want large cap stocks, that portion of your money might go into an index fund that mirrors the S&P 500. Using funds gives you even more diversity, because you're not counting on the performance of one single asset, but an entire group of assets in that class.

Want to check your portfolio's diversity? Investor information sites like Morningstar.com allow you to enter your picks and will spit out a graph that shows where your investment falls in terms of the various asset classes, says Berg.

"It gives you a quick and dirty" way to see just how diversified you really are, he says.

"For better or worse,

What about the family with many goals? A bigger home in five years; sending the kids to college in a decade and retiring 25 years from now? Don't mingle that savings or the plans, say some experts.

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"For better or worse, most of us live in an economy where it makes sense to segregate money for different goals," says Berg.

One solution: Get an education IRA or 529 plan for the kids, keep funding your retirement and look at a shorter-term savings vehicle for that house money.

Definitions

- Index fund -- fund made up of stocks represented in a particular index.

See the Guide's Glossary for a further explanation of these terms.

And, with the economy rocky, don't underestimate the importance of another asset: cash.

Especially now, investors "need to have a cash cushion as part of their plan," says Cabaniss, who recommends keeping six months of living expenses in a liquid form like a high-interest savings account, money market account or short-term CDs.

"In down times, it isn't so easy to get a job and if you don't have any reserves, you could be hurt."

Change of plans

During bumpy economic times, your asset allocation plan can serve as a touchstone to keep you on track. That can prevent you from giving in to panic and making some very costly mistakes. But one plan won't last a lifetime. You'll actually need several to reach your goal. The secret, say financial planners, is to use your life, not the ups and downs of the economy, as the signal to revisit your formula.

Important life events like changing retirement plans, divorce, remarriage, a significant windfall or change in cash flow, or the death of a spouse also signal times that you want to take another look at your allocation plan. Even if your life stays exactly the same, you want to revisit your plan every three years or so.

"Just ask yourself, does this still reflect me and my goals?" says Altfest.

Back on track

Drafting a plan is probably the most important step. But you also have to keep up with your money.

You might decide to keep your portfolio half in stocks and half in bonds. But over time, as various investments grow, you might end up with a 60/40 mix. That's why many financial planners "rebalance" the portfolio. When you rebalance, you shift assets back to the original proportions that you selected in your plan.

You might be able to rebalance from your own computer, says Berg. "Just go online to whoever is your 401(k) provider to see if this is available," he says.

So how often should you rebalance? That depends on your planner. Some advisers recommend every three months or even every time you reinvest money. Others have found that once a year is fine for most investors.

"At our firm, we find that a once a year checkup is sufficient," says Berg. In that period, "they haven't gotten too off track," he says. "You see 1 percent to 2 percent variance in a year, even in a volatile year."

"The important thing is that you annually rebalance the account," says Miller. "But you're also coming back saying, 'Am I comfortable with my risk tolerance?'"

Some planners set an allocation spectrum for their clients.

"You have a target asset allocation, and a minimum, and a maximum -- a range," says Swedroe.

Definitions

- Capital gain -- An increase in the price of something over and above what you paid for it. Capital gains receive favorable tax treatment.

See the Guide's Glossary for a further explanation of these terms.

When the asset grows or shrinks beyond that range, then it's time to rebalance. One word of caution: If you're holding assets in a taxable account, rebalancing could trigger capital gains taxes, he says. So check with your financial adviser or accountant.

Beware of playing or reacting to the market or the current economic climate, Miller says. Investors who try to play the ups and downs of the market "sabotage themselves," she says. "You really have to put asset allocation, diversification and rebalancing together."

Asset allocation can help investors weather those financial storms.

"There's nothing different about these times than any other times," says Swedroe. It's just that "the risk is showing up now."

But, he says, "If you build a plan for 30 to 50 years, there will be times like these showing up."

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