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ASSET ALLOCATION: A REFRESHER COURSE

Back to the Basics in Your Investment Portfolio

For many investors, managing their portfolios entails seeking out the latest "hot stock pick of the day," holding it for a relatively short time frame, and turning a quick profit. They marvel at the investment successes of the "genius" colleague in the next office cubicle or their brother-in-law's friend's wealthy business partner, and fail to realize that they never hear about those trades that don't quite pan out. Unfortunately, many who adhered to such a strategy were forced to put off retirement for a few additional years or find second (or third) jobs because Enron or (insert favorite defunct public company here) did not generate the level of returns they were anticipating.

It doesn't have to be that way

Asset allocation can be defined as the process of structuring a well-diversified investment portfolio comprised of multiple securities within various asset classes (equity, fixed income, cash) with different risk/reward parameters. Or, in its most simplistic terms…not putting all of your *investment* eggs in one *asset class* basket. Bear in mind, asset classes perform differently under changing economic or geopolitical climates. Stocks, for example, may experience excellent returns when the economy is growing, while bonds may struggle because rising interest rates and inflation often accompany such strength.

Since economic cycles can be unpredictable and incidents like natural disasters (Hurricane Katrina) occur without warning, investors would be well advised to maintain some percentage mix of both stocks and bonds within their portfolios. Under certain environments, some asset classes (and sub-classes) will outperform, while others take the lead as situations change. The investment goal should be to combine securities from the various asset classes into a portfolio that will provide an attractive return given an appropriate degree of risk (which will vary from investor to investor). In fact, each distinct portfolio should be created with the unique investors in mind and consider their specific financial goals, investment objectives, and the acceptable tolerances for risk. The financial advisor should adhere to the sound philosophy of "know thy clients" when determining the most appropriate allocations for their portfolios.

Through the years, studies have indicated that three factors primarily impact the performance of an investment portfolio: Asset allocation, individual security selection (stock picking), and market timing. Universally, this research reveals that the asset class composition (asset allocation) is the most important factor. In other words, the percentage of dollars invested within equities, fixed income, cash (and the sub-asset classes as defined below) is considered to be more significant than the actual individual securities themselves or exactly when those securities were purchased.

Sub-Classes

Equities

A properly allocated portfolio would not merely consider the overall mix of stock, bonds, and cash, but also the sub-classes within each. Equities are subdivided into market capitalization which depicts the relative size of the companies (outstanding shares times stock price) in terms of the overall market. Large-, mid-, and small-cap stocks all fall under the equity asset class, yet still maintain quite distinct risk/reward characteristics. In general, large-cap stocks are usually more established, mature companies in mature industries and are perceived as possessing greater

stability than their small-cap counterparts (though perception is not always reality). Small-cap companies often fall below the Wall Street radar screen and may struggle with anonymity until a specific event significantly impacts the price: FDA pharmaceutical approval, technology enhancement, acquisition candidate, bankruptcy. Though considered more risky than mid- and large-cap companies, these stocks offer significant upsides in the right environment.

Market capitalization:
- Large-cap
- Mid-cap
- Small-cap
- Micro-cap (smaller than small)

Equities can be further differentiated by valuation: Growth and value. Growth stocks typically offer greater upside price potential and may also possess more significant levels of risk should the economy slow or the related sector fall out of favor. Technology and telecom stocks, for example, often fall into the growth classification. Value stocks are deemed to be under-priced to the market and, thus, possess some upside potential but with less market volatility than their growth counterparts. Often they are purchased because of their dividend income as well as potential price appreciation. Utilities are considered a good example of a value sector. A properly allocated portfolio may contain some percentage of large-cap growth as well as small-cap value (and the various sub-classes in between).

Valuation:
- Growth
- Value
- Core (characteristics of each)

Sample Equity Asset Class Style Box*

				Capitalization
	Large-Value	Large-Core	Large-Growth	***Large***
	Mid-Value	Mid-Core	Mid-Growth	***Medium***
	Small-Value	Small-Core	Small-Growth	***Small***
Valuation:	***Value***	***Core***	***Growth***	

* Morningstar

Since the economy is becoming more global with each passing day, the equity asset class can also be subdivided by domestic and internationally based companies. In order to achieve greater diversification, investors may consider owning a percentage of foreign securities whose performance and risk characteristics are based on a number of very different factors. In today's environment, the Asian economies have experienced tremendous growth, and related markets (and companies) have generated significant returns.

Residency:
- Domestic
- International
- Global (combination)

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Fixed Income

Just like stocks, all bonds are not created equal (or maintain the same risk/reward characteristics). They can be differentiated by the debt issuer (US treasury, other government enterprise or municipality, corporation, etc.) and time to maturity. Again, a properly allocated portfolio may contain a percentage mix of each.

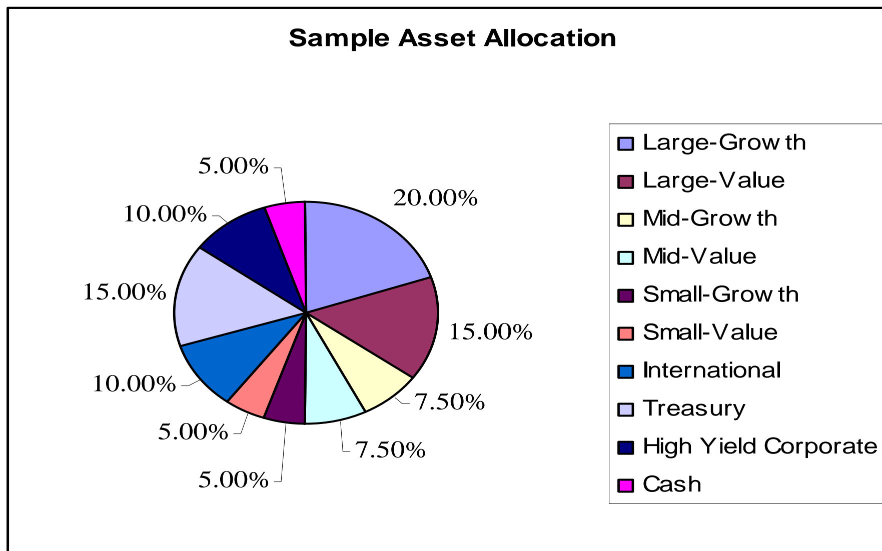
Treasuries represent debt obligations of the federal government. They are considered to be the safest of all fixed income securities and come with the "full faith and credit" backing of the government itself. Corporate and municipal securities not only fluctuate based on the economy and interest rate movement, but also the credit quality of the underlying issuer. Various services (Moody's, S&P, Fitch) review the financial viability of the issuers and assign a rating which helps investors identify the associated risk. The higher the rating, the lower the risk and the lower the expected return. Conversely, a lower rated bond (sometimes known as high yield or junk status) maintains higher return/income potential, but with a greater chance of issuer default. The longer maturing securities generally offer greater return potential (though not in the inverted curve environment of today…a story for another time), yet with greater volatility.

Issuer:

- Treasury
- Agency
- Corporate
- Municipal
- Asset-backed (mortgages, etc.)

Maturity:

- Short (within a year)
- Intermediate (less than 10 years)
- Long (greater than 10 years)



In the above example, nine distinct sub-asset classes (and cash) are combined to create a well-diversified portfolio. Regardless of the economic cycle or unpredictable geopolitical

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developments, this investor owns certain securities which will outperform others. Those which lag in the current environment may very well become the portfolio leaders when (not if) conditions change.

Asset Allocation Revisited

Many of today's investors understand the importance of asset allocation and the impact it can have on the return on their portfolios. After setting their goals and determining their acceptable risk tolerances, they structure portfolios by allocating an appropriate percentage of dollars to the various asset classes (and sub-classes). Without a crystal ball and the ability to predict which classes will be in favor over certain time frames, these investors are able to sleep better at night knowing they did not put all of their *investment* eggs in one *asset class* basket.