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ASSET ALLOCATION CAN SMOOTH THE BUMPS

In 2003 the rising tide of the stock market lifted all ships nicely. This year, most stocks have been stuck in a narrow trading range and investor expectations are guarded at best. Growth stocks are languishing while utilities and energy stocks hot. If it is not one thing it is another. How is an investor supposed to meet long-term objectives if they keep changing the markets?

Times like this remind us that by far the single largest determinant of a portfolio's success is asset allocation and not individual stock selection. Several studies have shown that the mix between stocks, bonds and cash or other asset classes accounts for over 90% of the difference in a portfolio's return over time. The rest can be attributed to individual stock selection. Understanding this powerful concept can help to eliminate a lot of second guessing and indecision when faced with various types of economic conditions and markets. The key to asset allocation is investing in assets with dissimilar performance. This is true because when investing in assets with similar behavior, whichever direction an investment takes, the others generally follow. With proper asset allocation, the upward movement of one asset may offset some part of the downward movement of another. In some years, stocks generate the best returns, while in others, the bond market is the place to be.

Most asset allocation decisions are driven by life circumstances, and it is important to understand that there is no one mix that is right all the time. For example, an allocation of 80 percent stocks and 20 percent bonds that worked well for you in your prime earning years may be totally inappropriate as you enter retirement. Similarly, the allocation that best suits your neighbor whose tolerance for risk is reflected in his penchant for BASE jumping may cause you to lose sleep.

Your investment goals, timeframe and tolerance for risk all figure into choosing an asset allocation that is right for you. Common investment goals include saving for a new or second home, a child's education, and a secure retirement. Your investment time horizon--the number of years before you will need the money to fulfill your financial goal--is another important factor. The further off your investment goal is, the more aggressively you can invest, since you have more time to weather the market's swings. As your investment horizon grows closer, your investment strategy should gradually become more conservative, shifting the focus from capital growth to capital preservation.

It is important to think of asset allocation not as an event, but as an ongoing process. This is because the distribution of assets in your portfolio is likely to fluctuate along with the market. A

run-up in the stock market could see your 70 percent stock and 30 percent bond allocation become 85 percent stock and 15 percent bond. A healthy portfolio should be analyzed and rebalanced if necessary several times a year. If you don't do this regularly and in a disciplined fashion, the market may do it for you. Neglect of this duty will cause you to have your maximum equity exposure at market tops, and your minimum equity exposure at market bottoms.

Instead of worrying about how some random or unexpected event will impact your ability to pay for a college education in five or ten years, work with a professional to figure out an appropriate asset allocation model. Over the years, a healthy, efficient and well–tuned portfolio will not let you down.

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