INVESTING: Asset allocation, diversification and rebalancing

Even if you are new to investing, you may already know some of the most fundamental principles of sound investing. How did you learn them? Through ordinary, real-life experiences that have nothing to do with the stock market. For example, have you ever noticed that street vendors often sell seemingly unrelated products - such as umbrellas and sunglasses? Initially, that may seem odd. After all, when would a person buy both items at the same time? Probably never - and that's the point. Street vendors know that when it's raining, it's easier to sell umbrellas but harder to sell sunglasses. And when it's sunny, the reverse is true. By selling both items - in other words, by diversifying the product line - the vendor can reduce the risk of losing money on any given day.

If that makes sense, you've got a great start on understanding asset allocation and diversification. This article will cover those topics more fully and will also discuss the importance of rebalancing from time to time.
Let's begin by looking at asset allocation.

Asset allocation 101

Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks, bonds, and cash. The process of determining which mix of assets to hold in your portfolio is a very personal one. The asset allocation that works best for you at any given point in your life will depend largely on your time horizon and your ability to tolerate risk.

Time horizon

Your time horizon is the expected number of months, years, or decades you will be investing to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable taking on a riskier, or more volatile, investment because he or she can wait out slow economic cycles and the inevitable ups and downs of our markets. By contrast, an investor saving up for a teenager's college education would likely take on less risk because he or she has a shorter time horizon.

Risk tolerance

Risk tolerance is your ability and willingness to lose some or all of your original investment in exchange for greater potential returns. An aggressive investor, or one with a high-risk tolerance, is more likely to risk losing money in order to get better results. A conservative investor, or one with a low-risk tolerance, tends to favor investments that will preserve his or her original investment.

Risk versus Reward

When it comes to investing, risk and reward are inextricably entwined. You've probably heard the phrase "no pain, no gain" - those words come close to summing up the relationship between risk and reward. Don't let anyone tell you otherwise. All investments involve some degree of risk. If you intend to purchase securities - such as stocks, bonds, or Unit Trusts - it's important that you understand before you invest that you could lose some or all of your money.

The reward for taking on risk is the potential for a greater investment return Investment choices while we cannot recommend any particular investment product, you should know that a vast array of investment products exists - including stocks and Unit Trusts, corporate and government bonds, Treasury Bills etc. For many financial goals, investing in a mix of stocks, bonds, and cash can be a good strategy. Let's take a closer look at the characteristics of the three major asset categories.

Stocks

Stocks have historically had the greatest risk and highest returns among the three major asset categories. As an asset category, stocks are a portfolio's "heavy hitter," offering the greatest potential for growth. Stocks hit home runs, but also strike out. The volatility of stocks makes them a very risky investment in the short term. Investors that have been willing to ride out the volatile returns of stocks over long periods of time generally have been rewarded with strong positive returns.

Bonds

Bonds are generally less volatile than stocks but offer more modest returns. As a result, an investor approaching a financial goal might increase his or her bond holdings relative to his or her stock holdings because the reduced risk of holding more bonds would be attractive to the investor despite their lower potential for growth.

Cash

Cash and cash equivalents - such as savings deposits, - are the safest investments, but offer the lowest return of the three major asset categories. The chances of losing money on an investment in this asset category are generally extremely low. The principal concern for investors investing in cash equivalents is inflation risk. This is the risk that inflation will outpace and erode investment returns over time.

Why asset allocation is important

By including asset categories with investment returns that move up and down under different market conditions within a portfolio, an investor can protect against significant losses. Historically, the returns of the three major asset categories have not moved up and down at the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns. By investing in more than one asset category, you'll reduce the risk that you'll lose money and your portfolio's overall investment returns will have a smoother ride. If one asset category's investment return falls, you'll be in a position to counteract your losses in that asset category with better investment returns in another asset category.

How to get started

Determining the appropriate asset allocation model for a financial goal is a complicated task. Basically, you're trying to pick a mix of assets that has the highest probability of meeting your goal at a level of risk you can live with. As you get closer to meeting your goal, you'll need to be able to adjust the mix of assets.

If you understand your time horizon and risk tolerance - and have some investing experience - you may feel comfortable creating your own asset allocation model. "How to" books on investing often discuss general "rules of thumb," and various online resources can help you with your decision. In the end, you'll be making a very personal choice. There is no single asset allocation model that is right for every financial goal. You'll need to use the one that is right for you.

Some financial experts believe that determining your asset allocation is the most important decision that you'll make with respect to your investments - which it's even more important than the individual investments you buy. With that in mind, you may want to consider asking a financial professional to help you determine your initial asset allocation and suggest adjustments for the future. But before you contacting anyone to help you with these enormously important decisions, be sure to do a thorough check of his or her credentials and disciplinary history.

Asset allocation and Diversification

Diversification is a strategy that can be neatly summed up by the timeless adage, "don't put all your eggs in one basket." The strategy involves spreading your money among various investments in the hope that if one investment loses money, the other investments will more than make up for those losses.

Many investors use asset allocation as a way to diversify their investments among asset categories. But other investors deliberately do not. For example, investing entirely in stock, in the case of a twenty-five year-old investing for retirement, or investing entirely in cash equivalents, in the case of a family saving for the down payment on a house, might be reasonable asset allocation strategies under certain circumstances. But neither strategy attempts to reduce risk by holding different types of asset categories.

Diversification 101

A diversified portfolio should be diversified at two levels: between asset categories and within asset categories. So in addition to allocating your investments among stocks, bonds, cash equivalents, and possibly other asset categories, you'll also need to spread out your investments within each asset category. The key is to identify investments in segments of each asset category that may perform differently under different market conditions.

One way of diversifying your investments within an asset category is to identify and invest in a wide range of companies and industry sectors. But the stock portion of your investment portfolio won't be diversified, for example, if you only invest in only four or five individual stocks. You'll need at least a dozen carefully selected individual stocks to be truly diversified.
Because achieving diversification can be so challenging, some investors may find it easier to diversify within each asset category through the ownership of Unit Trusts rather than through individual investments from each asset category.

Changing asset allocation

The most common reason for changing your asset allocation is a change in your time horizon. In other words, as you get closer to your investment goal, you'll likely need to change your asset allocation. For example, most people investing for retirement hold less stock and more bonds and cash equivalents as they get closer to retirement age. You may also need to change your asset allocation if there is a change in your risk tolerance, financial situation, or the financial goal itself.

But savvy investors typically do not change their asset allocation based on the relative performance of asset categories - for example, increasing the proportion of stocks in one's portfolio when the stock market is hot. Instead, that's when they "rebalance" their portfolios.

Rebalancing 101

Rebalancing is bringing your portfolio back to your original asset allocation mix. This is necessary because over time some of your investments may become out of alignment with your investment goals. You'll find that some of your investments will grow faster than others. By rebalancing, you'll ensure that your portfolio does not overemphasize one or more asset categories, and you'll return your portfolio to a comfortable level of risk.

When you rebalance, you'll also need to review the investments within each asset allocation category. If any of these investments are out of alignment with your investment goals, you'll need to make changes to bring them back to their original allocation within the asset category.

There are basically three different ways you can rebalance your portfolio:

1. You can sell off investments from over-weighted asset categories and use the proceeds to purchase investments for under-weighted asset categories.
2. You can purchase new investments for under-weighted asset categories.
3. If you are making continuous contributions to the portfolio, you can alter your contributions so that more investments go to under-weighted asset categories until your portfolio is back into balance.

When to consider rebalancing

You can rebalance your portfolio based either on the calendar or on your investments. Many financial experts recommend that investors rebalance their portfolios on a regular time interval, such as every six or twelve months. The advantage of this method is that the calendar is a reminder of when you should consider rebalancing.

Others recommend rebalancing only when the relative weight of an asset class increases or decreases more than a certain percentage that you've identified in advance. The advantage of this method is that your investments tell you when to rebalance. In either case, rebalancing tends to work best when done on a relatively infrequent basis.

(Source: Sec.gov, Investor)