Asset Allocation: *A Lifecycle Approach*

Do you have a specific formula for investing money in various asset classes? If so, you are an asset allocation investor. If not, you may want to consider this important investment strategy. That's because, although not guaranteeing a profit, allocating assets may maximize potential investment returns, while attempting to minimize risks. This is crucial for anyone who is building a retirement nest egg—or using retirement savings to generate current income.

Also important is devising an asset allocation consistent with your life stage. Since people's financial goals evolve as they move from one stage of life to another, their investment approach should change in turn. Asset allocation investing helps you make these course corrections as you travel through life.

So how do you get started with an asset allocation strategy consistent with your lifecycle stage? By first understanding:

- the rationale for asset allocation,
- the investor characteristics that suggest varying asset mixes, and
- approaches to implementing asset allocation

The rationale for asset allocation

"Asset allocation" sounds complex, but its essence is simple. It is the systematic process of diversifying your wealth among different investments such as stocks, bonds, and cash equivalents. Your goal is to achieve an investment portfolio with the highest potential return for the least amount of risk. Although, again, asset allocation does not guarantee a profit.

Why may "spreading the wealth" potentially improve returns and minimize risk? Because different types of investments —or asset classes—respond differently to economic or political changes. For example, stocks perform well when the economy is growing, but lag when a recession strikes. Conversely, bonds perform strongly when an economy is holding steady, but lose value when inflation or higher interest rates appear. So, your goal is to build a diversified portfolio of assets whose responses to economic events tend to reinforce or neutralize each another over time.

A basic allocation involves spreading money across three asset classes: stocks, bonds, and cash or cash equivalents. Then for each of these, money is spread across several sub-classes to achieve further diversification (international stocks, large-cap stocks, etc.). To succeed with this strategy, notes investment expert David Darst, "the right asset classes with the right properties need to be blended together in the right proportions."*

In fact, many experts suggest that focusing more on the asset mix and less on picking individual stocks, mutual funds, or investment managers can be a more effective strategy, long term.

**Source: "The Art of Asset Allocation: Asset Allocation Principles and Investment Strategies for Any Market" by David Darst. McGraw Hill, 2003*

Investor characteristics

But how do you determine the right allocation? By forging the right mix of assets for your current lifecycle stage.

Put simply, every investor has two impulses: to grow assets or to protect assets. Where you fall depends on your life stage. If you are fresh out of college, you probably will want maximum potential asset growth. To achieve this, you will tolerate a higher amount of risk in return for maximum potential gain. If you are in your peak family formation and child rearing years, you may still want to grow assets, but your risk tolerance may be lower, since you'll need to put your kids through college or buy a bigger house. And if you are only a year or two away from retirement—or already retired—you will tilt toward principal protection.

As you select an asset mix consistent with your life stage, Darst suggests you consider four personal characteristics:

- **Expected time horizon:** the longer your investment horizon, the more you should focus on asset growth and on investments consistent with growth (e.g. equities).
- **Income needs:** the greater your needs for current or imminent income, the more you should focus on principal protection and investments consistent with income (bonds, CDs, money markets)
- **Purchasing power protection:** the more you are concerned about inflation eroding your purchasing power, the more you should focus on asset-growth investments and the less on principal-protection investments.
- **Volatility tolerance:** the less appetite you have for volatility, the more you should focus on principal protection assets.

Implementation approaches

Interested in implementing asset allocation? First step is to consult your investment professional. This person can provide an asset allocation analysis based on your life stage and risk tolerance. Once you have a target asset mix and begin allocating your money into various classes, don't change the mix every time the market shifts. Stay the course, while periodically bringing your portfolio back into balance as investments grow or fall at various rates. Finally, revisit your allocation percentages periodically as your needs change. This will assure that your allocation reflects the reality of your life today, not the life you had yesterday.

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