The Importance of Asset Allocation

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One important part of investing is the principal of asset allocation, or the way in which investments are weighted in a portfolio among different types of assets, or asset classes. Asset allocation can be simple concept that can be integral to long-term investment success. In fact, a landmark study cited in the Financial Analysts Journal shows that about 90% of the variability of average total returns earned by balanced mutual funds and pension plans over time was the result of asset allocation policy.[1]

For plan sponsors, who have a fiduciary responsibility to understand the structure, costs, and fees of their plan, knowing what asset allocation is and applying it can be critical.

A strategy may include representation from different types of assets. These can be divided into three basic asset classes: stocks, bonds, and money market securities.

- Stocks -- Known for fluctuating frequently in value, stocks carry a high level of market risk over the short term. However, stocks have historically earned higher returns than other asset classes, although past performance is no predictor of future results. Stocks have also outpaced inflation -- the rising prices of goods and services and therefore carry lower inflation risk.
- Bonds -- In general, these securities have less severe short-term price fluctuations than stocks, and therefore offer lower market risk. On the other hand, their overall inflation risk tends to be higher than that of stocks, as their long-term return potential is also lower. Bond returns may be influenced by movements in short-term interest rates. When interest rates rise, bond prices are likely to fall.
- Money market instruments[2]-- Among the most stable of all asset classes in terms of returns, money market instruments carry very low market risk. At the same time, these securities don't have the potential to outpace inflation by as wide a margin.

Diversifying among several asset classes can lower the overall risk in a portfolio by increasing the chance that, if and when the return of one investment is falling, the return of another may be rising, though there are no guarantees and asset allocation is no assurance against investment loss.

Sample Asset Allocations*

Risk Level						
Low		Moderate		Aggressive		
% Treasury Bills	30	30	20	10	0	10
% Bonds	40	30	30	40	30	20
% Growth Stocks	30	30	40	30	50	70

% Small Caps	0	0	0	10	10	0
% International	0	10	10	10	10	0

Chart illustrates sample portfolio asset allocations: Low Risk (those nearing or in retirement); Moderate Risk (middle-aged investors); Aggressive Risk (younger investors).

*Allocations are presented only as hypothetical examples and are not intended as investment advice.

The above chart illustrates how plan participants can determine an appropriate allocation based on their life stage and appetite for risk. Generally, an individual's asset allocation will change as he or she reaches different stages in life. For instance, a 25-year-old can afford to take on higher risk than, say, a person who is nearing retirement. His investment goal typically is to achieve as much growth as possible -- growth that will outpace inflation substantially. In aiming to reach this goal, he might allocate 70% of his assets into aggressive growth stocks, 20% into bonds, and 10% into money market instruments, since he has years to ride out the wide fluctuations that come with stocks. For the pre-retiree, however, protecting what he may have saved and earned over the years may be more important. He may want to gradually shift some of his stock allocation into bond and money market holdings. Keep in mind, however, that many financial experts recommend that stocks be considered for every portfolio to maintain growth potential.

A Retirement Program Specialist can provide further guidance on the importance of asset allocation.

Sources:

[1]"*Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?*" Financial Analysts Journal, January/February 2000.

[2]An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

Investing is subject to market risks including loss of principal.

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