

DETERMINING THE APPROPRIATE ASSET ALLOCATION

Jason Johnson and Wade Polk*



Perhaps the most fundamental of all investment decisions relates to asset allocation. Simply stated, asset allocation is the selection of investments from the various asset classes, which are generally categorized as cash, hard assets, stocks and bonds. Each asset class is affected by different circumstances and has values that do not move in the same direction at the same time. The purpose of asset allocation is to distribute your investments so that you achieve a level of return consistent with your objectives and risk tolerance profile.

It is estimated that more than 90 percent of the variation in investment returns over time is a result of asset allocation. So, determining the appropriate asset allocation is crucial to investment success. For every investment goal there is an asset allocation that strikes a delicate balance between risk and reward. For example, based on data compiled by Ibbotson Associates through 1998, money market investments offer day-to-day stability but earn the smallest returns over long periods.

Stocks tend to earn more long-term, but their value can fluctuate significantly along the way. Bonds fall somewhere between the two in potential growth and safety. So how should you allocate your assets?

Investment Goals

The first step is setting your investment goal. Some common investment goals are: to build sufficient assets for a comfortable retirement; to finance a child's college education; or to make a down payment on a home. If you have more than one goal in mind, you might want to allocate assets specifically for each goal. Investment goals help you focus on why you're investing and keep your plan on course when market volatility tempts you to change your investment strategy. Your risk tolerance is your ability or willingness to endure declines in the value of your investments while you wait for them to return a profit that will help you meet your investment goal. Consider how you would react to a 20 percent decline in the value of a stock investment—a typical "bear market" occurrence. Over the past four decades, bear markets have occurred, on average, about once every 5 years.

Time Horizon

Your investment goals all have a time horizon, and that is an important consideration when determining appropriate investments. Your time horizon is the number of years you have available to invest. It includes the time until you reach your goal, as well as the period during which you make withdrawals from your investment. For example, if you are saving for retirement, your time horizon should include not only the time until you retire but also the years you plan to live off of retirement savings. Similarly, if you are saving for college, your time horizon should include the number of years until your child starts school, plus the years during which he or she will be enrolled. The longer the time until you will need the money, the more time you have to weather periodic (and sometimes drastic) swings in the market. Longer time horizons allow you to select more aggressive investments, assuming you aren't averse to risk. As time goes by, your portfolio has less time to recover from market dips, so you might choose to shift gradually to a more conservative asset allocation.

* Assistant Professor and Extension Economist—Management and Extension Program Specialist—Risk Management, The Texas A&M University System

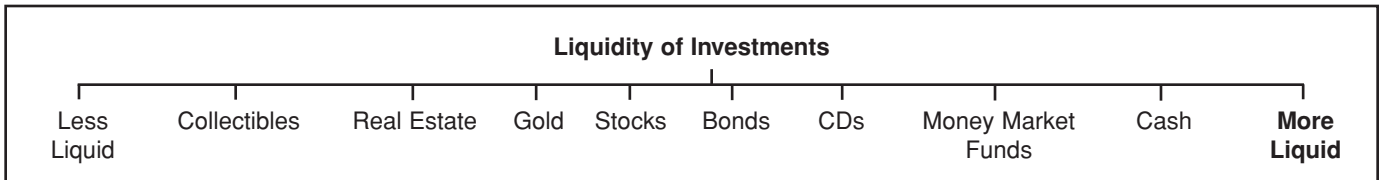


Figure 1. Relative liquidity of various investment options.

Liquidity

Liquidity refers to the ease with which an investment can be converted to cash. Financial planners generally recommend that you set aside 3 to 6 months' worth of living expenses (depending on the stability of your income) in a readily accessible account for unforeseen emergencies. These are liquid assets. Different asset classes have different levels of liquidity. Liquidity is less of a consideration for money invested to meet longer term goals.

Diversification

Diversification is a key component of asset allocation. A diversified portfolio is one with a variety of asset classes that don't tend to rise or fall in value at the same time. Spreading your investments across a variety of classes is important because each type responds differently to market, inflation, interest-rate, currency and default risks. This moderates the effect of a poor performance by any one asset class. For instance, a strong economy may cause stock values to rise, but it could also bring rising interest rates, which tends to cause bonds to decline in value. On the other hand, a stock may struggle in a weak economy while bonds may gain value because of falling interest rates. In short, investing in several asset classes can help you benefit from changing economic conditions while protecting you from adverse price swings.

Asset Classes

The typical asset classes are cash, hard assets, stocks and bonds. Cash investments include money market accounts, certificates of deposit (CDs), and U.S. Treasury bills.

Hard assets include collectibles, real estate and gold. The value of hard assets grows either with inflation or as the result of market (supply and demand) factors. The value of hard assets can increase or decrease greatly; therefore, timing is important if they are to be effective investments.

You can invest in the stocks of either domestic or foreign companies. Stock investments also can be categorized by the size of the companies (their market capitalization). The terms large-, mid- and small-cap stocks refer to companies with a total market value of more than \$5 billion, between \$750 million and \$5 billion, and less than \$750 million, respectively. A growth stock is one issued by a company whose revenue is expected to grow more than the average. Growth companies tend to reinvest most of their earnings, and therefore pay small dividends as the price of the stock increases. A value stock is one issued by a company whose assets are considered more important than the company's long-term earning potential. Income stocks usually denote mature companies with stable earnings and dividends.

Bonds are debt instruments. When you buy bonds you are basically playing the role of a banker and lending money to a corporation or a government (local, state or federal). The bond issuer pays you regular interest, and repays the initial investment at a future date.

Figure 2 presents a chart of options to help you evaluate the asset allocation choices. When deciding how you will invest, consider all the factors mentioned previously. Then look at the expected risk/reward tradeoff implied with different investment options by evaluating historical returns.

Historical Returns of the Asset Classes

Expected return is an estimate of what the asset class will earn in the future based on historical performance and economic projections. As the adage goes, past performance is not a guarantee of future results, but it can help you make educated decisions. If returns are volatile (vary widely from year to year), an investment is considered high-risk. Table 1 shows the historical performance of various asset classes from 1926 through 1997, as well as the percent of the time the classes have had positive returns. The inflation figures illustrate the risk of losing purchasing power that all investments face, especially those in fixed-income assets.

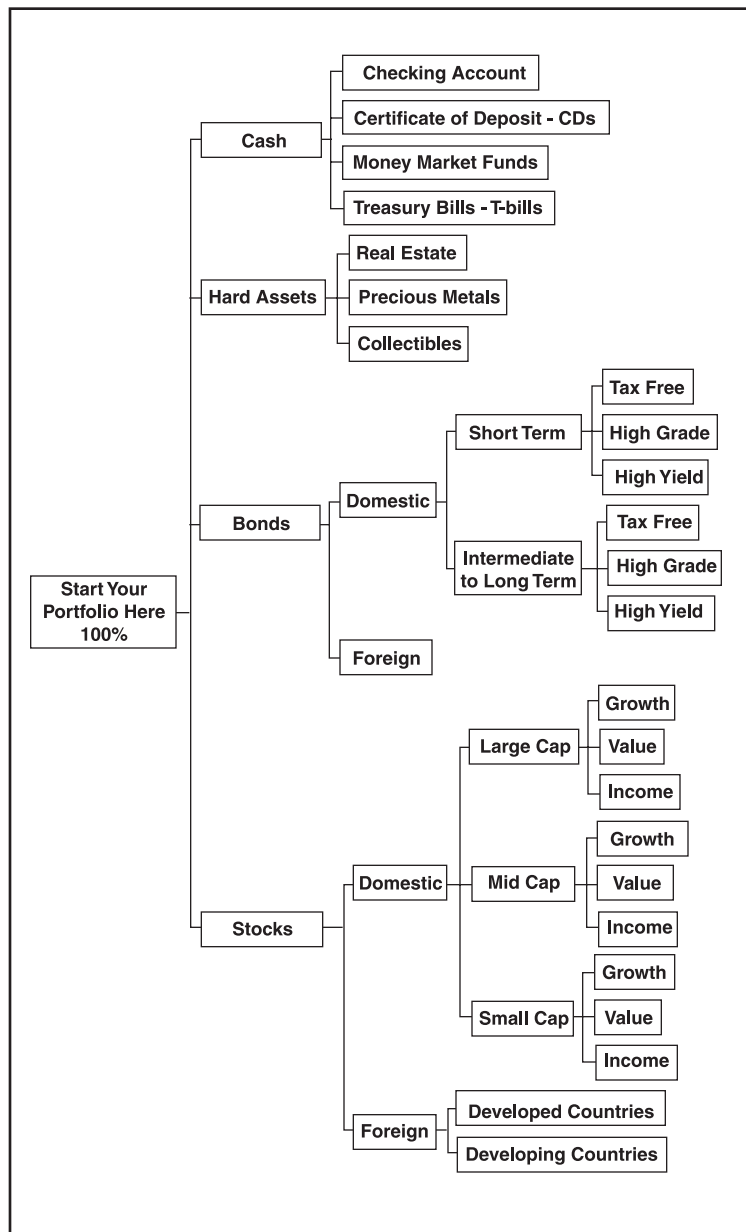


Figure 2. Investment options to choose among when making asset allocation decisions.

For further information:

Ibbotson, Roger G. and Rex A. Sinquefeld. *Stocks, Bonds, Bills and Inflation Yearbook*. Ibbotson Associates: Chicago, Illinois, 1998.

Lummer, Scott L. and Mark W. Riepe. "The Role of Asset Allocation in Portfolio Management," *Global Asset Allocation: Techniques for Optimizing Portfolio Management*. John Wiley & Sons: Toronto, 1994.

Morris, Virginia B. and Kenneth M. Morris. *A Woman's Guide to Investing*. Lightbulb Press: New York, 1998.

Table 1. Historical Returns of Major Asset Classes, 1926 -1997.

Asset class	Best year	Worst year	Compound annual return	% Positive years
Small Company Stocks	142.9%	-58.0%	12.7%	71%
Large Company Stocks	54.0%	-43.3%	11.0%	72%
Long-Term Corporate Bonds	42.6%	- 8.1%	5.7%	78%
Long-Term Government Bonds	40.4%	- 9.2%	5.2%	72%
U.S. Treasury Bills	14.7%	0.0%	3.8%	99%
Inflation	18.2%	-10.3%	3.1%	86%

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