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Balancing a Retirement Portfolio with Asset Allocation

There is no guarantee that any investment strategy will be successful; all investing involves risk, including the possible loss of principal. And remember that asset allocation and diversification can't guarantee a profit or eliminate the possibility of potential losses, including the loss of principal.

The combination of investments you choose is as important as the individual investments themselves. In fact, many experts argue that it's even *more* important, since the mix of various types of investments accounts for most of the ups and downs of a portfolio's return. Each type of investment, or asset class, has strengths and weaknesses that let it play a specific role in your overall investing strategy. Some investments, such as stocks, may be chosen for their growth potential. Other asset classes, such as bonds, may provide regular income. Still others may offer relative stability or serve as a place to park money temporarily. And some investments may try to fill more than one role.

Balancing how much of each asset class you should include in your retirement portfolio is one of your most important tasks as an investor. That balance between growth, income, and safety/stability is called your asset allocation. It can help you manage the level and type of risks you face.

Balancing risk and return

Ideally, you should strive for an overall combination of investments that take the least amount of risk in trying to achieve a targeted rate of return. This often means balancing more conservative investments against others that are designed to provide a higher return but that also involve more risk.

For example, let's say you want to get a 7.5% return on your money. You've read that in the past, stock market returns have averaged about 10% annually, and bonds roughly 5%. One way to try to achieve your desired 7.5% return would be by choosing a 50-50 mix of stock and bond investments. It might not work out that way, of course. This is only a hypothetical illustration, not a real portfolio, and there's no guarantee that either stocks or bonds will perform as they have in the past. But asset allocation gives you a place to start.

Someone who is close to retirement and about to start relying on his or her savings for living expenses will probably need a very different asset allocation than a young, well-to-do working professional whose priority is saving for a retirement that's 30 years away. The level of risk you are able to take is known as your "risk tolerance," and it's affected by factors such as how soon you'll be using your savings as well as your emotional and financial ability to handle setbacks.

Don't forget about the impact of inflation on your retirement savings. As time goes by, your money will probably buy less and less unless your portfolio at least keeps pace with the inflation rate. Even if you think of yourself as a conservative investor, your asset allocation should take long-term inflation into account.

Many ways to diversify

In addition to thinking about how to divide your assets among stocks, bonds, and cash — the three basic asset classes — consider how your assets are allocated within an asset class. For example, for the stock portion of your portfolio, you could allocate a certain amount to a mutual fund that invests in large-cap stocks, and a different percentage to one that focuses on stocks of smaller companies. Or you might allocate based on geography, putting some money in U.S. stocks and some in those of companies overseas. Bond funds will vary based on the underlying bonds they hold, and are subject to the same inflation, interest-rate, and credit risks associated with them. Those differences will affect a fund's yield and volatility. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance. Cash alternatives such as a money market fund can be used to park money until you decide how to invest it. Once you've covered the basic three asset classes, there may be others that can be used to diversify further.

There are various approaches to choosing an asset allocation that makes sense for you. One approach is to look at what you're investing for and how long you have to reach each goal. Those goals get balanced against your immediate need for money — for example, to pay living expenses. The more secure your

Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Obtain a copy of the prospectus and read it carefully before investing.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Though a money market fund attempts to preserve a $1 per share value, there is no guarantee it will always do so, and it's possible to lose money investing in the fund.

immediate income and the longer you have to pursue your investing goals, the more aggressively you might be able to invest for them. That means your asset allocation might have a greater percentage of stocks, which are considered riskier than bonds or cash but which also might offer greater potential long-term return.

Or you might be in the opposite situation. If you worry that you might need to tap your investments in an emergency, you'll need to balance that fact against your longer-term goals. In addition to establishing an emergency fund, which would lower the odds of your needing to tap your retirement account prematurely, you may need to invest more conservatively than you might otherwise want to.

Some investors believe in shifting their assets among asset classes based on which types of investments they expect will do well or poorly in the near term. However, this approach, called "market timing," is extremely difficult even for professional investors. Less experienced investors often tend to put money into an asset class that has performed well recently, only to watch that strong performance disappear shortly after they've invested.

Some people try to match market returns with an overall "core" strategy for most of their portfolio. They then put a smaller portion into very targeted investments that may behave very differently from those in the core and that provide greater overall diversification. These often are asset classes that an investor thinks could benefit from more active management.

Your asset allocation should balance your financial goals with your emotional needs. If the way your money is invested keeps you awake worrying at night, you may need to rethink your investing goals and whether the strategy you're pursuing is worth the anxiety.

Check your asset allocation yearly

Even if you've chosen an appropriate asset allocation, market forces may quickly begin to alter it without any action on your part. If stock prices go up, you may eventually find yourself with a greater percentage of stocks in your portfolio than you want. If stock prices go down, you might worry that you won't be able to retire when you hope to — or at all.

Let's say you initially decided on an 80% to 20% mix of stock investments to bond investments. If stocks perform well, you might find after several years that your portfolio is now divided 88% to 12% (conversely, if stocks haven't done well, you might have a 70-30 ratio of stocks to bonds in this hypothetical example). You should review your portfolio periodically to see if you need to return to your original allocation.

Also, your asset allocation should take into account any changes in your life and circumstances — for example, if you get married, divorce, have children, change jobs, or get close to retirement. Even if your asset allocation was right for you when you first chose it, it may not be right for you now. It should change as your circumstances do. A piece of clothing you wore 10 years ago may not fit now; you just might need to update your asset allocation, too.

That's why it's important to review your portfolio periodically to make sure your asset allocation is still appropriate for your current situation and financial goals. Doing a checkup at least once a year — for example, at the end of the year — can help keep your portfolio on track.

If you need to bring your asset allocation back to the original percentages you set for each type of investment, you may need to do something that can feel counterintuitive: sell some of what's working well and use that money to buy investments in other asset classes that now represent less of your portfolio than they should. Typically, you'd buy enough to bring your percentages back into their original amounts.

Let's go back to the example above, in which stocks now represent 88% rather than the 80% you originally intended. To rebalance, you would sell some of the stock and use the proceeds to buy enough of other asset classes to bring the stock allocation back to 80%. The same would be true if stocks dropped; to rebalance, you would invest in stocks until they once again reached the proper percentage. (However, if rebalancing were done in a taxable account, selling investments could result in a tax liability.)

If you need to rebalance your portfolio but don't want to sell assets in order to do so, you could take a more gradual approach to shifting your asset allocation. Simply direct new contributions to your retirement plan account into asset classes that have been outpaced by others, or that are new to your portfolio. That can help change your asset allocation over time and minimize the risk of making a major change at the wrong time. But if you don't review your holdings periodically, you won't know whether a change is needed.

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