

# Asset allocation is always important



When putting together your investment strategy, it's helpful to keep in mind the age-old saying that "the whole is greater than the sum of its parts". Investment portfolios that are invested in a number of asset classes work together to even out performance in both bull and bear markets, taking into account your risk tolerance and time horizon.

You might own shares in some great companies, but there will be times when property, bonds or even cash deliver better returns. The difficulty is that not even the professionals can predict when the performance of one asset class will peak or another will return to form.

## Asset allocation

The process of dividing your money between asset classes with different characteristics is known as asset allocation. As you gradually build a portfolio, you need to think about how much weight to give each investment and asset class.

For example, a balanced portfolio might contain 60 per cent growth assets which carry higher risk such as shares and property and 40 per cent defensive assets such as bonds and cash which are typically lower risk.

Your actual asset allocation is a personal decision and will depend on your time horizon and your ability to tolerate risk.

For some people, the volatility of high-risk investments is not worth the sleepless nights they cause, even if the potential rewards are greater. This is especially the case for retirees or people nearing retirement who have less time to recoup market losses.

A sharp price fall at the wrong time can cause havoc for anyone who depends on the income from their investments or needs to sell an asset to release some cash. But investors who have a decade or longer to ride out a market cycle can afford to accept more risk.

## Risk and reward

All investment involves a trade-off between risk and reward. Shares and property tend to outperform bonds and cash over the long haul, but with more volatility along the way.

One way to reduce the risks of investing is through diversification, otherwise known as not putting all your eggs in one basket. By holding shares of companies in a range of industry sectors you will not lose everything if one stock turns out to be a lemon or one part of the economy struggles.

But diversification within one asset class only protects you so far. If there is a major downturn in shares or property, even good investments may lose value for a time.

Take the example of Australian shares. In 2008, in the aftermath of the global financial crisis, shares plunged 38.9 per cent while bonds were the top-performing asset class with a return of 15 per cent<sup>1</sup>. The following year shares were the top performer, up 37.6 per cent, while bonds limped in second last with a return of just 1.7 per cent.

And that is where diversification across asset classes is important, but not in a haphazard way.

Many individuals were caught out during the financial crisis by not having any bonds in their

portfolio to soften the blow of falling share and property prices. By combining assets with returns that show little or no correlation, you can smooth out your annual returns and reduce risk at the overall portfolio level.

## The big picture

Inexperienced investors tend to focus on whether to buy shares in this or that company, or an investment property in this or that suburb, but this is like putting the cart before the horse.

The first thing a good adviser does is to work out an investment plan and asset allocation tailored to your personal circumstances, the returns you need and your tolerance for risk.

The professionals distinguish between two types of asset allocation that individual investors might also find helpful.

- Strategic asset allocation is the asset mix that you think is most likely to meet your long-term investment goals. The percentage you set for each asset class becomes a benchmark or target. As prices move up or down, an investment that was originally 5 per cent of your portfolio's value might grow to 10 per cent. When this happens you may need to 'rebalance' your portfolio by selling some of your winning investments, buying undervalued assets, or both.
- Tactical or dynamic asset allocation is used in response to market cycles. Say for example that you think Australian shares are overpriced but interest rates are rising, you might make a tactical decision to shift some of the money you have in local shares into cash or bonds.

No matter whether there is a bull or bear market, the ultimate goal of your personal investment strategy is selecting the mix of investments that has the best chance of delivering the returns you need, when you need them, with an appropriate level of risk. Speak to your financial adviser about the right investment mix for you.

<sup>1</sup> Russell Investments, "Which asset should I choose", [http://www.russell.com/AU/\\_pdfs/investor-edu-comms/investor-toolkit/R\\_NEWS\\_Toolkit\\_Divers\\_V1F\\_WEB\\_1001.pdf](http://www.russell.com/AU/_pdfs/investor-edu-comms/investor-toolkit/R_NEWS_Toolkit_Divers_V1F_WEB_1001.pdf), viewed 26 May 2013