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ASSET ALLOCATION

Savvy Investors Know This Is the Crucial Investment Decision

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WOMEN'S FINANCIAL REALITIES ARE SOBERING

In our first entry, "Taking the Lead: Facing the Financial Realities Unique to Women," we saw the stark effect of the financial realities that women face. Since women are in a position where, on average they earn less, yet live longer, they must be excellent financial stewards to make sure that they are able to enjoy retirement in good financial standing.

SAVINGS: THE SECRET TO LONG-TERM SECURITY AND CONFIDENCE

Clearly, in order to be excellent leaders, it is vitally important to take care of our own financial houses. In the next part of the series, we learned the importance of savings and how to get started. We saw how small changes made a big difference and could contribute to our overall confidence and presence. For reference, "How Saving and Investing Your Money Strengthens Your Confidence and Leadership Presence" is available on our website.

THE CRUCIAL INVESTMENT DECISION: ASSET ALLOCATION

By now, you've saved money and are having consistent success at that. You are now ready to invest! You ask, "What stock do I buy?" And then you proceed to tell a story about a neighbor who bought a particular stock and made a fortune in a month. Yikes! You are asking the wrong question.

While some people love to talk about winning stocks at cocktail parties, these are seldom the sum total of their investment experience. (Behind that story is usually a long list of investments that very likely not only didn't work out, but also did very poorly, costing them a lot of their savings.) And such storytelling sets the stage for you to focus on the wrong aspects of investment decisions.

In this entry of our series, we will share with you the process of constructing an investment portfolio to create long-term wealth. It might not be an exciting story about the "big fish" or the best stock investment ever. But this process can give you the security of creating an investment plan that works in many types of market environments. Isn't it better at the end of the day to build real wealth than to be able to tell a gun-slinging story?

So, what is asset allocation? To begin with, it is the most crucial investment decision you will make. Asset allocation refers to how much of your assets you are going to invest in stocks versus bonds. The importance of this decision is described below, but first let's have a quick primer on the differences between stocks and bonds.

Stocks are also known as equities. They represent a share or ownership interest in a company. When the company does well, you would expect the stock price to rise and you would benefit as a shareholder. Companies may pay dividends to their shareholders, either in the form of cash or more shares of stock. Similarly, if a company does poorly, you would expect the stock price to decline. In general, stocks or equities are considered investments that have both higher risk and higher return.

Bonds, sometimes referred to as fixed income, represent a loan that you have made to an entity such as the U.S. Government, your local school district, or a company. Bonds typically involve interest payments from the bond issuer (one of the entities mentioned above) to you, the bondholder. When the bond matures at a set point in time, you receive back the initial principal that you loaned the issuer.

Bondholders do not receive additional compensation at maturity if a company or entity does well, nor do they receive less if it does poorly. They receive a fixed schedule of payments. Bonds are generally investments that have both lower risk and lower return.

The Impact of Asset Allocation

The exciting stock selections or one-time investments that people love to talk about are not the investment decisions that really drive long-term returns and long-term wealth. As a leader, you will want to know the different classes of assets that you can invest in and focus on determining the right asset allocation for you. It is also important to realize that your allocation decision will explain over 90% of the returns that you earn on your investment.

Historically, investors have experienced one type of return (and the risk associated with that return) for investing in stocks and another type of return for investing in bonds. This risk and return relationship has a far greater impact on your portfolio return than whether you buy stock in Company A or Company B or Company C! A study of pension plan returns found the selection of which asset classes to invest in and how much to invest in each explained 91.5% of the return variation. The remaining 8.5% of variation was explained by the combination of market timing, specific stock selection and other factors.[1] Hopefully this helps illustrate for you why asset allocation truly is the critical decision when planning how much to invest – how much to invest in stocks, how much to invest in bonds and how much to leave in money markets.

The Important Relationship Between Risk and Return

When people tell stories about their great investments, they make it sound as if the investments are without risk. Financial news coverage does the same. This is a great disservice, as all investments carry a certain amount of risk. Within an asset class, securities share certain expected risk and return characteristics. Think about a hypothetical investment that has an expected return of 8% per year. It has higher risk and so you might expect that in any given year, the potential range of investment returns would be between 28% and negative 12%. (This range of returns is expected 2/3 of the time. It does not mean that it cannot be higher or lower.) Another hypothetical investment you might consider only returns 4%, but its possible range of expected outcomes is between 2% and 6%.

If someone only told you about the expected returns, you might think that it sounded a lot better to earn 8% than to earn 4%! However, when you learn about the potential ranges of outcomes, you can see that some investments are riskier and have broader ranges of outcomes, on the low side as well as the high. You might be more comfortable owning an investment with the lower expected return, but also the lower risk and the narrower range of possible outcomes.

As you consider investments in stocks and bonds, it is important to realize that it is best to implement your exposure to each of these in broadly diversified funds or portfolios. While we will learn more about this in the next blog post, you should know that for now this means that if you decide to invest 60% of your investment portfolio in stocks, it does not imply that you would own one, two or even ten stocks. It implies that you will own as much of the broad market of stocks as you can – you want exposure to large capitalization stocks and small capitalization stocks as well as value stocks and growth stocks. Again, don't worry too much about that right now, as we'll cover that in more depth in the next blog post.

Typically, you will want to consider investing a portion of your assets in riskier choices, like broadly diversified stocks, and a portion of your assets in less risky choices, such as broadly diversified bonds. How much? That is a personal question and depends on just how much variation in performance (and quite possibly negative performance) you can bear in any given year to achieve long-term returns. A typical starting point is to consider a portfolio that includes 60% broadly diversified stocks and 40% broadly diversified bonds. You can adjust from there to suit your tolerance for risk. Some investors will choose to own more stocks and are willing to take the bad years with the good years. Some investors will prefer to own a higher proportion of bonds to ensure a greater cushion. Remember, more risk produces a higher expected return. But, it also can produce negative returns in the short run.

The Asset Classes To Consider

Now that you are ready to begin constructing an investment portfolio, you will note the use of the phrase "broadly diversified equities." Ideally, you would invest in large capitalization stocks, small capitalization stocks, international stocks and even emerging markets stocks! To diversify your fixed income investments, you might invest in highly rated (credit safe) bonds, high yield bonds, non-U.S. bonds and bonds from emerging markets. Within those categories would be further diversification by including government and corporate bonds as well as mortgages. You might also include a portion of cash or money markets in your portfolio to give you a safety net.

As a savvy investor you now know that you should not be making investment decisions based on the hot stock tip from the pizza delivery person or even your manager! Instead, you are wise enough to realize that you need to consider a portfolio that contains stocks and bonds and that the proportion of each will determine both the expected return and the expected risk of your investment.

Now it is time to ask about how to make those broad investments in stocks or bonds. We will tackle that issue in the next entry. Please watch for:

- Importance of Diversification: Strong leaders know better than to put all their eggs in one basket.
- Women leaders have the confidence to stay the course in investments as well as strategic plans.
- Effective leaders know when and how to delegate: Finding a financial advisor.

The author is passionate about people both learning to make smart investment decisions and getting appropriate guidance in those decisions. You can learn more about Janice here: http://www.hewinsfinancial.com/ourteam-janice.html.

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1. Mark Brinson, G.P., Singer, B.D. and Beebower, G.L., "Determinants of Portfolio Performance II: An Update", Financial Analysts Journal, May-June 1991.

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