

Chapter 1

Understanding Asset Allocation

In This Chapter

- ▶ Appreciating the importance of asset allocation
 - ▶ Discovering how to apply asset allocation to your portfolio
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pssst! Want to know the trick to making a killing in investments? One that offers fat financial returns with little or no risk? Sadly (and as you'd probably guess), there's no such thing.

Want to know how you can score great long-term investment results while minimizing unnecessary risk and costs? In that case, you've come to the right place! With the right asset allocation, you can enjoy substantial investment returns with the lowest possible amounts of risk and cost.

Asset allocation, in simplest terms, is deciding how to divvy up your investment dollars among various types of assets. More fully, it's a comprehensive, coherent, top-down, strategic approach to investing that has well-established science and years of real-life superior investment results to back it up. In other words, it's bona fide, and when it comes to investing, nothing consistently beats it.

In this chapter (and throughout this book), we show you how and why asset allocation works and, perhaps more important, how it can work for you. We take you step by step through the time-tested approach to investing that the most successful professionals use. We explain how you can reap the benefits of rebalancing, which is the closest thing to a free lunch you'll ever find in investing. And we show you how to do all this and save on your taxes, too!

In true *For Dummies* fashion, Chapter 1 is a microcosm of the book that follows. Think of this chapter as a bird's-eye view of asset allocation. We hit all the high points, and, as we go, we point you to the chapters you can visit to get a more detailed treatment of each topic.

Figuring Out Why Asset Allocation Is So Important

When it comes to your investments, what's more important than asset allocation? In our opinion — and in the opinion of most every reputable investment expert — nothing.

In this section, we clue you in on why asset allocation is so important, using a couple different perspectives. First, we use the infamous story of Enron to show you the terrific power of diversification, which is one of several fundamental aspects of asset allocation. Then, to give you a feel for asset allocation's other key aspects, we use the rest of the section to take a broader view, exploring what independent studies have to say about the role of asset allocation in driving investment success.

Encapsulating the Enron story

Here's the short version of the Enron story: Beginning in the early 1930s as a modest oil pipeline company, Enron grew over the years, through mergers and acquisitions of other energy companies. By the late 1990s, it was very aggressive in energy trading and other complicated financial engineering ventures. (Don't worry about the details — it was really, really complex stuff.) Enron had, in fact, become an industry leader and business-school case study in the creative use of these sophisticated financial arrangements. By early 2001, Enron had grown to be the seventh largest company in the United States based on revenue and had been named America's Most Innovative Company for the sixth year in a row by *Fortune* magazine. It was also on *Fortune's* 100 Best Companies to Work for in America list in 2000.

Then the bottom fell out. Before the end of 2001, Enron was bankrupt. The cause was accounting fraud. The lengths to which Enron's executives went to conceal their illegal activities were epic in their ingenuity and complexity. That's the white-collar-crime part of the story that was splashed all over news headlines for months. But that's not the worst part.

The worst part — and the part most relevant to you, the average investor — was this: Even while the Enron executives were perpetrating their fraud, they were encouraging their own employees to stake their financial futures on the company. In addition to offering an employee stock ownership plan (ESOP), Enron urged its employees to invest in company stock in their retirement plans. The company's matching contributions to its employees' 401(k) plans were made exclusively in Enron stock. And, in the fall of 2001, as its fraudulent financials were unraveling, Enron made it impossible for its employees to switch out of Enron stock in their retirement plans.

It was a real tragedy for thousands of Enron employees, who watched helplessly as their retirement funds and personal financial futures evaporated. Sadly, it happened because Enron led them to violate one of the immutable laws of sound investing: Never, *ever* put too many of your eggs in one basket.



Keep your investments diversified! Don't invest too much in any one security, especially your employer's stock. (Enough of your financial future is already tied to the company's well being.) As a general rule, don't invest more than 5 percent of your invested assets in any one stock.

So that's the enduring lesson of Enron for investors: Diversify, diversify, diversify! Asset allocation begins with portfolio diversification, but as we describe later, it goes much further.

Exploiting the 90 percent solution

Quick — what decision will have the biggest impact on your investment results? It's not *stock picking* (chasing so-called “hot” tips on individual securities, usually without regard to a coherent portfolio strategy) or *market timing* (trying to beat the market by timing when to get in and get out of it). The lion's share of your performance will be determined by your asset allocation — how you divide your money among various types of assets.



According to several well-regarded academic studies over the years, over 90 percent of the difference in returns among various investment portfolios is explained by one thing: asset allocation. That fact alone should lead you to a profound revelation: You should spend the vast majority of your investing time and effort on getting your asset allocation right. Nothing else matters nearly as much.

Separately, study after study has shown that investors who take other approaches, such as market timing or stock picking, consistently underperform the market averages over the long term.

But if those types of dubious investment strategies have been shown to fizzle out in the long term, why do you see so much newsprint and radio and TV airtime devoted to them? Why are most of the stories about market timing and stock picking instead of asset allocation? Because those other things are sexy. They're exciting. And they play to our baser instincts — our desire to jump into the next great low-effort, get-rich-quick scheme. By contrast, asset allocation is a steady and reliable approach that takes some thought and consideration. In other words, it's relatively unexciting. But it's the investing approach the pros have used for decades to get better long-term results than those other guys. (Check out the “Appreciating the science of asset allocation” sidebar in this chapter to find out why.) Asset allocation gives you a much better chance of ending up with more money in the long run. How's that for unexciting?

Appreciating the science of asset allocation

Sometimes, asset allocation and its associated activities seem counterintuitive. It may make you uncomfortable, particularly when those around you are doing the opposite of what you're doing (buying when you're selling, selling when you're buying, avoiding investments you're embracing, and so on). At those times, reassure yourself with some knowledge of the science behind what makes asset allocation work.

One of the principles of asset allocation is the reduction of portfolio volatility. Excessive volatility can cost you real dollars because of a phenomenon called *risk drag*. As we explain

in Chapter 2, risk drag eats away at your investment return over time. By combining the right investments in the right proportions, you can tame risk drag.

Finding those investments and determining those proportions is also a matter of some science. The trick is to find investments that don't *correlate* very well with each other (meaning, they don't all go up or down at the same time). Investments like that may seem unappealing to new investors, but those in the know realize that they can use them to create real portfolio magic, as we show you in Chapter 4.

And here's the best news of all: You don't have to be a financial genius or fork over a huge wad of cash to a world-class broker or an elite hedge-fund manager to reap the rewards of asset allocation. You just need to understand the basics and figure out how to apply those basics to your personal investment situation.

The rest of this chapter shows you how to do just that.

Uncovering the Basics of Asset Allocation

Successful asset allocation involves a few basic concepts. These main components, which form the centerpiece of Part I, are as follows:

- ✓ Understanding the fundamental relationship and trade-off between investment risk and return
- ✓ Selecting the asset classes that are right for you
- ✓ Determining the right mix of those asset classes to achieve your objectives
- ✓ Rebalancing your portfolio periodically to maintain your desired mix

We take you step by step through these basics in this section.

The complete asset allocation picture contains other less basic features (developing your investment strategy in the context of your long-term financial plan, filling your portfolio with the right securities, putting those securities into the right accounts to get the best after-tax results, measuring your performance, and so on), which we cover a little later in this chapter.

Balancing risk and return

Risk and return are the two central concepts underlying all of investing. To enjoy a return on your investments, you have to take some risk. Although *return* (your percentage gain) can be measured with objective precision, risk is a very personal, subjective concept. Whether you define your own concept of risk as uncertainty, instability, the chance of losing money, lack of peace of mind, or in some other manner, one thing is generally true: The more return you want, the more risk you have to accept. As you consider the length of time over which you'll be investing, your ideas about risk and return may change in surprising ways. You can read all about these concepts, including the all-important trade-off between risk and return, in Chapter 2.

The risk-return trade-off has been the subject of much academic study. One of the really useful tools that has emerged from all that study is the *efficient frontier*. It might sound a little cold and complicated, but it's really a simple visual device that'll help you reach a deep understanding of asset allocation's core concepts and guide you toward the asset allocation that's right for you. We show you how to use the efficient frontier in Chapter 2.

Selecting your asset classes

An early step in asset allocation is determining the *asset classes* (groups of investments with similar characteristics) that you want in your portfolio. In Chapter 3, we take you on a tour of the asset classes at your disposal. There are traditional classes, such as cash, fixed-income investments (including bonds and bond funds), and equities (including stocks and stock funds). We cover issues such as maturity, creditworthiness, and taxability of the various types of fixed-income investments, as well as the size, style, and sector of your equity investment choices.

We also dig into so-called *alternative investments*, which can help stabilize your portfolio. These include real estate, hard assets (such as commodities), and hedge funds. And we discuss going global with international investments in all these areas.

Many of the asset classes you can invest in may have unique and important roles to play in your portfolio, so it's wise for you to get to know them as well as you can.



Determining your asset mix

In addition to knowing what kinds of assets are available for you to include in your portfolio, you also need to understand how to mix those assets in the right proportions.

To best appreciate how the right mix works for you, and to help you find your ideal mix, you really need to understand *correlation* (the way your various asset classes behave in relation to each other). We can't stress the importance of correlation enough, and you can dive into the details in Chapter 4.

The holy grail of investing is a set of asset classes that have perfect *negative correlation* with each other, meaning that one zigs when the other zags (that is, if one moves up, the other moves down by the same amount, at the same time). Asset classes like that can be combined to create a portfolio that has absolutely no risk! But, as you may imagine, perfect negative correlation — like perfection of any kind — is impossible to find in real life (with the exception of chocolate peanut butter ice cream), so you try to get as close as you can. You can reduce risk drag (see Chapter 2) considerably, and thereby improve your portfolio's return, just by properly mixing assets that have positive, but weak, correlation. In Chapter 4, we show you how to let these ideas guide your decisions on asset mix.



In determining how much of an asset class to include in your portfolio, keep in mind that the characteristics and behavior of any one asset class on its own are irrelevant. What really counts is the behavior of the *entire* portfolio when that asset class is added to it. This is a guiding principle of asset allocation. (We cover how to put this principle to practical use in Chapter 8.)

Rebalancing your asset mix

Setting up your asset mix isn't the end of asset allocation. The financial markets, where investors buy and sell securities, will see to it that different asset classes inside your portfolio will grow at different rates. Over time, your portfolio will, therefore, drift away from the mix you set up so carefully. When that happens, you'll need to occasionally buy and sell assets to get your portfolio back to your target allocation. That process is called *rebalancing*.

Rebalancing on the right schedule will do more than keep your portfolio faithful to its asset allocation. It'll help you rein in risk. More surprisingly, it'll also help you generate extra return seemingly out of thin air! That's what we mean when we say that rebalancing is the closest thing to a free lunch you'll ever find in investing.

Rebalancing sounds great, right? It really is, and you can read up on the details in Chapter 5. Rebalancing forces you to buy low and sell high. It allows you to exploit a phenomenon called *volatility pumping* to get you that extra return. But you have to have the fortitude to do it correctly, because it'll require you to do things at times that are contrary to what others around you who haven't read up on asset allocation are doing. But the payoff is worth it: Rebalancing will reduce your risk and ramp up your long-term returns.

Getting Started with Your Investment Strategy

As you can read in the previous section, Part I of this book is all about understanding the basic tenets of asset allocation. That's crucial stuff, and it's tough to do much with asset allocation if you don't have a grasp on the basics. But when you've wrapped your brain around them, how do you make those basics work for you? The next step is developing a well-considered investment strategy, and that's what you can discover in Part II.

As we outline in Chapter 6, your strategy should lay out the following parameters:

- ✓ **Your investment horizon:** This is the length of time you expect to be invested. It's critically important to get this right, and here's a big clue: It may be longer than you think.
- ✓ **Your return objectives:** This isn't the return you want, but the return you need. We help you determine your return objectives when we discuss your long-term financial plan, later in this section.
- ✓ **Your risk tolerance:** However you define your subjective concept of risk, there's likely a point — a limit — beyond which you're just not comfortable going. We show you how to use this tolerance level to find your best-performing asset allocation.
- ✓ **Your portfolio constraints:** You may have certain investments, or even whole asset classes, that you just won't consider for personal reasons (for example, maybe you won't invest in a tobacco company because your father died of lung cancer, or you won't invest in a beer company because drinking is against your religious beliefs) or certain holdings that you just won't let go of (maybe you just can't bring yourself to sell the stock your grandma left to you). We explain how to deal with these limitations.

- ✓ **Your tax situation:** Your tax bracket may lead you to consider certain asset classes that wouldn't make sense for you otherwise. We discuss how you can exploit this situation.
- ✓ **Your special circumstances:** If you have an unusual exposure to lawsuits (due to your profession, perhaps) or an overriding desire to protect your assets from estate taxes, we describe how you might make certain adjustments to your portfolio.

You should set these investment strategy parameters after looking at your long-term financial plan. We show how to do that in Chapter 7, where we introduce another useful tool, your Lifetime Cash-flow Projection (LCP). We're not going to lie: Developing your LCP is the most work we ask you to do in this book. Compared to some of the other tasks, it can feel like heavy lifting. You don't have to do it if you don't want. We're not saying you can't get yourself a decent asset allocation without an LCP, but we really don't think you should cut corners when it comes to your financial future. In addition to helping you derive the asset allocation that's just right for you, your LCP also allows you to test any number of critical "what if" scenarios as you go through life. We also advise you to document your investment in an Investment Policy Statement, just as the pros do.

Speaking of the pros, in Chapter 8, we show you how they would use all this information to derive an ideal asset allocation for you. We show you what you can learn from them to do it yourself. We also give you a head start by showing some sample asset allocations and taking you step by step through an example with a fictional couple, John and Jane Doe.

Building Your Portfolio and Keeping It True to Your Long-Term Goal

After you've settled on your asset allocation (you've assigned target percentages to all the asset classes you want in your portfolio), then what do you do? That's when it's time to do some shopping. You have to buy securities to put in your portfolio to achieve the allocation you decided on. When you do that, you have to figure out in which of your various investment accounts to buy the securities. (You keep your securities in accounts, and determining which accounts should hold which securities is an important process.)

But if you're smart, you won't stop there. You'll diligently monitor your portfolio, so that, among other things, you'll know when you need to rebalance. And finally, you'll want to measure your portfolio's results in a meaningful way to gauge whether all this is working the way you want. We cover all these things, in turn, in this section and throughout Part III.

Selecting securities

Within each of the asset classes we outline in Chapter 3, there are scads of securities you can buy to represent the asset class. With thousands of possibilities, how do you choose? In Chapter 9, we take you on a tour of the securities available to you. There are stocks and bonds, of course. There are also mutual funds and exchange-traded funds, and we explain why we generally prefer the latter over the former. We also discuss index funds and actively managed funds, annuities, options, structured notes, exchange-traded notes, and others.

To keep your asset allocation in ship shape, you'll want to buy different securities in different circumstances. Sounds logical enough, but what's the best way for you to actually *buy* securities? You have a couple of broad choices: You can buy them on your own or buy them through a broker. There are advantages and disadvantages to each approach, and we cover all the relevant information in Chapter 9. You can also, if you dare, use shorting and/or leverage to expand your opportunities. We're not crazy about the prospects of those techniques for new investors, but we know you'll hear about them as you continue to grow as an investor, so we fill you in on the details.



Any security you buy carries a cost. Some of those costs — like trading commissions — are explicit; others — 401(k) management fees, for example — aren't. Some can be quite large. We provide a very complete catalog of fees and expenses that you may encounter and tell you how to uncover and compare them.

Mastering asset location

That's right — we said “location,” not “allocation.” *Asset location* is the tactic of matching your securities with your accounts in an optimal way to exploit all the tax advantages you can. If you choose the location of your assets wisely, you can save a bundle in taxes. (Flip to Chapter 10 to read more.)

Throughout the book, we advise you to do your asset allocation on a holistic basis (that is, across all your investment accounts in the aggregate). Those accounts may include an individual taxable account for you and, if you're married, one for your spouse. Maybe the two of you have a joint account or two. And then there are IRAs, 401(k)s, health savings accounts, and more. When you really sit down and think about it, you may be surprised by just how many accounts you have. You should consider them all in total when you apply your asset allocation.

That doesn't mean that you apply the same allocation percentages to each of the accounts — quite the contrary. The reason? Taxes. Each of the securities you may want to buy has its own income-tax characteristics, and some are more tax-friendly than others. And each of the accounts you own has specific tax features. Some are fully taxable, some are tax deferred, and some may be tax free. You can save a lot of taxes by being clever about which securities you locate in which accounts. In Chapter 10, we take you through a detailed example, using the Does (a fictional couple we introduce in Chapter 8), to show you how to be tax smart at the account level while achieving your desired asset allocation at the portfolio level.

Monitoring your portfolio to stay on target

The rebalancing that we talk about earlier (and in depth in Chapter 5) can provide you substantial benefits. (Remember that rebalancing is what we call the closest thing to a free lunch you'll ever find in investing.) But to get those benefits, you have to rebalance at the right times.



The “right time” to rebalance can't be scheduled in advance. These times aren't specific calendar dates; they occur when your portfolio drifts away from its target asset allocations by a sufficient amount. So, you need to keep tabs on your portfolio to make sure you don't miss those rebalancing opportunities.

In Chapter 11, we go through this rebalancing exercise with the Does. As we also discuss in that chapter, there are additional reasons to diligently monitor your portfolio. The individual securities you own may suddenly go sour and start losing value. Or, after a good run, they may simply run out of steam. When you add a security to your portfolio, you should set guidelines around its market price. Those guideline prices will act as useful triggers, to let you know when you should review the security and possibly remove it from your portfolio.

You also want to monitor your portfolio to be on top of opportunities to take advantage of certain tax-saving tactics, such as tax loss harvesting, which we discuss in more detail in the “Tackling taxes” section, later in this chapter.

Measuring your results

You may have heard the old saw “You can't manage what you can't measure.” When it comes to investing, that nugget is a golden one. So it's certainly worth knowing how to measure your investment results the right way.

In Chapter 12, we outline the following five key elements for understanding your investment results and putting them in meaningful context:

- ✓ **Principal:** The amount you invested
- ✓ **Term:** The length of time over which you're measuring your results
- ✓ **Risk:** The degree of safety built into your investment
- ✓ **Opportunity cost:** The results you could've gotten for a typical alternative investment with similar risk over the same term
- ✓ **Suitability:** The degree to which this investment is in step with your financial plan

We show you how to express your results as a return, to address the first two elements — principal and term. Then, to cover the next two elements — risk and opportunity cost — we explain how to derive, and compare your return against, relevant benchmarks. Finally, we revisit your LCP, which we discuss earlier in this chapter and in Chapter 7, to help you determine the suitability of your investment and to track future progress.

Reaching Past the Asset Allocation Basics

If you establish the best asset allocation for your situation, pick your investments carefully, mix them together in the right proportions, rebalance them when appropriate, and do all the other things we describe in this chapter, you can become a savvy investor with a consistent, successful portfolio. And as your investing knowledge and experience continue to grow, you can add some other ideas and techniques to your asset allocation arsenal. These beyond-the-basics items are the focal point of Part IV.

Adding alternatives

Alternatives are those investments that go beyond the traditional asset classes of cash, fixed income, and equities. In Chapter 13, we examine a wide range of alternative investments — from pork bellies to property — and tell you how you can buy them. We also review what the right alternatives can do for your portfolio by allowing you to exploit their poor correlation — their tendency to zig in the market when your other investments zag.

Tackling taxes

It's not what you make, but what you keep, that counts. In Chapter 14, we share some tactics that the pros use to minimize their income taxes. We look at tax-smart selling, we revisit asset location, and we expand on tax-loss harvesting, which is a way that you can take lemons (in this case, losses) and make lemonade (tax breaks). But we also warn you against going too far. The best investors recognize that the real goal is not minimizing taxes, but maximizing after-tax results.



Don't let saving taxes get in the way of intelligent investing.

Altering your allocation

You also want to be alert to revisiting your asset allocation over the years. Although your asset allocation is designed for the long haul, you don't want to be blind to changes — in your own situation and in the environment around you — that should trigger a return visit to the assumptions you relied on to establish your allocation. We explore these changes, and your appropriate responses, in Chapter 15.

Embracing expert help

Even the most talented do-it-yourselfer needs the support of an expert now and again. You can be an asset allocation ace and still need to call on a professional financial advisor for help on a specific challenge or with a particular facet of your investment strategy (or even for the whole ball of wax).

Chapter 16 is devoted to helping you determine just what kind of assistance you may need and where to find it. We guide you through the labyrinth of professional designations and tell you which ones are the most meaningful and relevant for your needs. We give you a set of probing questions to ask potential advisors, so you can separate the wheat from the chaff. And we explain advisors' various means of getting paid, so you can be sure that their incentives are in line with your own.