

## ASSET ALLOCATION RISK

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How should you allocate your investments? This is one of the more important decisions facing every investor, and unfortunately, there is no shortage of rules of thumb. For instance, with regard to bond investments, one rule suggests you should have an allocation equal to your age, while another suggests you should have an amount that allows you to “sleep well at night.” The problem with these rules of thumb is the focus is on *risk*, and while risk is an important consideration in the investment allocation decision, it should not necessarily be the driving consideration.

Consider one of the more common asset allocation risks – being too conservative. This is more common in older investors who, fearful of losing money during a market downturn, rely almost exclusively on cash and bond-type investments to meet their lifetime income needs. Unless they have large cash resources, relative to their needs, adopting such a short-term investment strategy can actually be quite risky because it reduces the likelihood of earning a real return over time – a positive return after accounting for inflation and taxes. By being too conservative your expenses could easily outpace your earnings, causing you to consume your principal and increasing the likelihood of outliving your money.

Another asset allocation risk is being too aggressive. This is more common when investors rely on a small pool of investments to provide for their lifetime income needs. Because they require a higher investment return, they usually have a larger exposure to stock investments. During market downturns, they experience a double whammy – being forced to take distributions from their investments at a time when prices are depressed. The usual result is a more rapid depletion of their investments and, eventually, outliving their money.

So what should you do? The key to success can lie in a balanced investment portfolio that focuses on your *need*. By considering historical rates of return from various investment categories, you can construct an asset allocation strategy targeting a rate of return that, if achieved, can provide for your unique, long-term need. For instance:

- If you are already retired – determine your required distribution rate (inclusive of taxes) and add your annual inflation assumption. Then allocate your investments in a manner that targets that rate of return.
- If you are currently working and saving for your future – identify the retirement nest egg required to provide for your lifetime income needs. Based on your current investments and planned savings, determine the required rate of return to accumulate your nest egg. This required rate of return, if achievable, should drive your allocation decision.

Utilizing this approach can assist in making an asset allocation decision that focuses on your rate of return first (i.e., need), while attempting to minimize the risk associated with earning that rate of return. After all, why would any investor choose to take excess risk just for the sake of it?

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