Asset Allocation : A tutorial for mutual fund investors

Asset Allocation

Asset Allocation is the selection of different types of assets, and the amount you invest in each asset type, to meet your investment goals, risk tolerance and time horizon. Different types of assets respond differently to the same event, such as a change in the economy. They also have different expected returns and amounts of risk. Simply put, the objective of asset allocation is for you to achieve your investment goals with the minimum amount of risk. Asset allocation is one of the two most important investment decisions you will make. (Selecting your individual investments, within your asset classes, is the other.)

Our easy to use Asset Allocation tool weighs ten different variables and will help you determine the asset mix best suited for you. If connected to Internet Use this free Asset Allocator tool.

Types of Assets

The principal asset types, or classes, you'll choose from are:

- Short term investments – money market funds (taxable or tax-free) or interest-bearing bank accounts.
- Equities – stocks of publicly traded companies.
- Fixed Income – corporate (taxable), municipal (tax-free) or US Government debt securities.
- Real Estate – real estate companies, such as REITs.

There are many other asset classes such as commodities, currencies, gold, and art, to name a few, but they are neither necessary nor appropriate for most investors to achieve their investment goals.

By the way, there is no such thing as a "guaranteed" investment, except maybe for U.S. Treasury securities. Money Market funds are not insured by the Federal Government. Guaranteed annuities are only as safe as the company which sponsors (guarantees) them, or in the case of variable annuities, the investment vehicles you select. The same is true for all forms

of insurance.

Investment goals change over time. Your asset mix also changes due to the performance of your investments and may need to be rebalanced. Periodically reviewing both is a good idea.

Required Return

You may wish to start by figuring out how much money you'll need and when you need it. Common goals include having enough money to pay for a child's college education or retirement. Be sure to leave a cushion for the unexpected. Once you have this figure, you can work backwards to today to determine what rate of return you need to earn on your investments, including expected future savings, to achieve your end result. Our Mutual Fund Screener will help you do this.

You also may wish to compare your required rate of return to expected or historical rates of return on various asset classes. A starting point for this exercise is to review returns of the best performing mutual funds in each class, and then weight those returns according to your asset mix.

You can utilize our Mutual Fund Screener tool to sort mutual funds by investment type, returns, expense ratios, and more. If connected to Internet Use this free Mutual fund Screener.

If you're happy with the result – great! If not, you have three choices: save more, reduce the amount you need, or look for investments with higher expected returns.

Risk versus Return

The higher the return you want to achieve, the more risk of loss you have to accept. Over the long term stocks have returned more than corporate bonds and corporate bonds have returned more than U.S. Treasury securities, but stocks are riskier than bonds and bonds are riskier than government securities.

Risk does not just mean the possibility of losing money, it also means volatility. Even successful high return investments will fluctuate more in price along the way than more conservative investments. Stock funds fluctuate more in value than money market funds. A fund investing solely in biotech companies fluctuates more in value than a fund investing in the biggest blue chip companies. It's normal to get nervous when an investment goes down

in price but if the risk of loss or the interim price fluctuations will be too much for you to stomach, then the investment isn't right for you. Avoiding investments which are too risky for you will help you avoid the mistake of selling a good fund when the market's down, which is a sure way not to achieve your investment goals.

Time Horizon

Time is your best friend. The longer you have until you need to draw on your investments, the lower return you'll need to meet your goal or the less risk you'll need to take. The compounding effect, or time value of money, works in your favor. That's why it's so important to start saving early.

But, perhaps ironically, the longer you can wait until you need your money, the more risk you can take. This is because you can wait out the price volatility of riskier investments. Take the Dow Jones Industrial Average, for example. It declined three years in a row from 2000 – 2002 but it recovered to end 2006 at a record high. If you had to sell your equity funds in 2002 you might not have been very happy. You surely would have been happier if you held them until 2006.

Diversification

Investing in different asset classes is a form of diversification but the concept also applies to selecting individual investments within asset classes. Diversification is a method of reducing the chance that a specific event could affect your entire asset class in the same way. Simply put, it means don't place all your eggs in one basket.

Investing in two big cap (market capitalization, which tends to correlate to the size company) U.S. company stock funds provides a little diversification because it reduces your dependence on a single manger, although both funds probably will own many of the same stocks. Investing in a big cap U.S. stock fund and a mid-cap U.S. stock fund will give your greater diversification because there will be little, if any, overlap in the stocks they buy. Buying a big cap U.S. stock fund and a fund that invests in the securities of foreign companies will provide even greater diversification because the factors affecting the stock will not be as similar as if all the stocks were in the same country

If you are connected to Internet Click here for Mutual Fund Performance Calculators

Saving enough? How much can you save? Will you have enough for retirement? These are just some of the questions

answered by our Retirement Calculators, for which, if you are connected to Internet, **CLICK HERE**