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Personal Financial Literacy

Lesson 14

Asset Allocation

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ABU DHABI COUNCIL FOR ECONOMIC DEVELOPMENT

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Asset Allocation

Asset Allocation is an investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance and investment horizon. The three main asset classes – equities (mostly stocks), fixed-income (mostly bonds), and cash and equivalents – have different levels of risk and return, so each will behave differently over time.

Asset allocation is the first step in deciding the right mix of asset classes for your investments – one that balances risk and reward against your long- and short-term goals. These goals are based upon many factors including an investor's age, their family situation, their income, their wealth, etc. For example, you may allocate 60% of your retirement savings to stock funds and 40% to fixed-income funds at middle age, but reverse the allocation when you approach 60.

The next step is to decide what funds to choose within each asset class. This process is called diversification. In the example above, you decided to allocate 60% of your retirement savings to stock funds. You diversify by selecting several different types of stock funds. The more diversified your portfolio is, the less likely any one investment choice can hurt you with a poor performance.

A portfolio should be diversified at two levels: among asset categories and within asset categories. So in addition to allocating your investments among stocks, bonds, cash equivalents and possibly other asset categories(asset allocation), you may also want to consider spreading out your investments within each asset category.

The key is to identify investments in segments of each asset category that may perform differently under the same market conditions.

Studies and mathematical models have shown that maintaining a well diversified portfolio of 25 to 30 stocks will yield the most cost-effective level of risk reduction. Investing in more securities will still yield further diversification benefits, albeit at a drastically smaller rate.

Further diversification benefits can be gained by investing in foreign securities because they tend be less closely correlated with domestic investments. For example, an economic downturn in the U.S. economy may not affect Japan's economy in the same way; therefore, having Japanese investments would allow an investor to have a small cushion of protection against losses due to an American economic downturn.

Most non-institutional investors have a limited investment budget, and may find it difficult to create an adequately diversified portfolio. This fact alone can explain why mutual funds have been increasing in popularity. Buying shares in a mutual fund can provide investors with an inexpensive source of diversification.