Unbiased Financial Information Provided by Financial Wisdom.

Asset Allocation and a Bumpy Stock Market

How you divide your investment portfolio among stock, bond and cash investments is called asset allocation. It can serve as a logical starting point for your investment strategy. Individuals should base their asset allocation on their time horizon and risk tolerance. Here are some sample allocations based on age:

Age	Stocks	Bonds	Cash
30's	65%	25%	10%
40's	60%	30%	10%
50's	50%	40%	10%
60's	30%	55%	15%

Evaluating Risk Tolerance
With this as a starting point, you can then review your risk tolerance. Here are some questions that can help you understand how you feel about risk. There are no right or wrong answers.

1. You have done your homework and bought $5,000 of a stock you believe has very good growth potential. Two months after your purchase, the entire stock market declines and your stock is down 15%. Do you:
A -- Sell all of it.
B -- Sell half of it.
C -- Hold it.
D -- Buy more.

2. You work for a small and growing technology company. The company's owners are offering the employees the opportunity to buy stock in the company. They anticipate taking the company public sometime in the next three to five years. If you buy the stock, you will have to hold it until a public market exists, and it pays no dividends. Do you:
A -- Buy none.
B -- Buy one month's salary's worth.
C -- Buy three month's salary's worth.
D -- Borrow money and buy a year's salary's worth.

3. Which would you rather have done?
A -- Invest in a money market fund currently paying about 4%.
B -- Invest in an electric utility stock paying a 3% dividend with the potential for modest growth.
C -- Invest in a portfolio of blue chip companies with a chance of earning average market returns.
D -- Invest in two risky medical technology companies with a chance of significant gains or losses.

4. You are on a TV game show. Which would you choose?
A -- $5,000 in cash.
B -- A 50% chance of winning $10,000.
C -- A 20% chance of winning $25,000.
D -- A 10% chance of winning $100,000.

Now let's go back and evaluate your answers. In each case, A answers are worth 2 points, B answers are worth 4 points, C answers are worth 6 points, and D answers are worth 8 points.

Add up the points for the answers you selected. The higher your score, the more willing you are to assume higher risk to earn higher returns. The midpoint of the possible scores is 20.

There is no exact way to modify the model asset allocations, but if your score is between 22 and 28, you should considering adding up to 10% percentage points to your equity allocation, with reductions primarily in bonds. If you are very risk-tolerant, with a score above 30, you might want to increase your equity exposure by up to 15%. But doing this is an aggressive move.

If you are a risk avoider, with a score between 12 and 18, you could reduce your equity exposure by up to 10%, with increases in bonds and cash. If your score is less than 12, you don't like risk at all. You should consider reducing your equity exposure by 15%.

Periodic Reviews
Reviewing your allocation on a periodic basis to make sure it still matches your objectives makes sense. You may have added more funds to certain sectors, you get older and your risk tolerance can change. Usually an annual review is enough. Rebalancing generally makes sense if your actual allocation has deviated more than 5% from your objective.

Effect of a Volatile Market
With the swings in the stock market of the past few years, reviewing your asset allocation regularly is prudent. When the market was going up in the late 1990s, many individuals' allocation became over-weighted with equities. If they did not take any action to bring the allocation back into balance, they probably ended up being hurt when the market turned down.

You may want to consider reviewing your asset allocation on a semiannual basis. Here is a chart that can help. Be sure to include all your investment assets:

Asset	Stocks	Bonds	Cash
Retirement plans	$	$	$
IRAs	$	$	$
Investment accounts	$	$	$
Bank accounts	$	$	$

Mutual funds	$	$	$
Total	$	$	$
Allocation % ages	_____ %	_____ %	_____ %

Compare these allocation percentages with your current asset allocation. Using asset allocation can help provide some discipline to your investment strategy.

This article is meant to be educational only. Every individual must consider his/her specific situation when making investment decisions. The services of a qualified professional can help in this process. Remember, past performance is no guarantee of future results.