

Asset Allocation and the Life Cycle

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As the world economy continues to expand and grow and more and more people are investing in the markets, the need for an understanding of asset allocation over the stages of ones life has increasingly grown in importance. Asset allocation by definition is the practice of divvying up one's assets into different classes such as stocks, bonds and mutual funds. It can also be further divided in some classes by sector. This allows for more diversification on a smaller scale and helps to reduce risk without completely abandoning an asset class.

Different Asset Classes

There are many different asset classes which investors can use to diversify with. Each has its particular strengths and weaknesses and should be researched by the investor and or his financial manager to see which ones will best suit his needs. No same portions of asset classes will work for 2 investors. Each portfolio should be tailor made to fit the individual's needs and future goals.

US Domestic Equities (Stocks)

When the average person thinks of investing, they think of stocks in companies they know such as Microsoft and Google. While at times it may be intelligent to invest in such companies there is much more work to be done when figuring out which stocks should be bought.

Growth vs. Value

The choice between growth and value stocks for an investor depends on their investment strategy and future needs. Growth stocks are generally priced higher than

the broader market and are less sensitive to economic conditions. As indicated by past performance, they do have high earnings growth reports however it should be noted that past performance does not indicate future results. Value stocks on the other hand are priced lower than the overall market and are priced similarly to other companies in that industry.

When looking at growth stocks, one will look for high quality companies that have posted consecutively high returns and have good future growth prospects. Investors would buy these stocks if they were looking for capital gains income from the stock appreciating in price. These are often risky due to their high Price to Earnings ratios and can often be volatile.

Choosing value stocks is often done more by looking at company's fundamentals. Value stocks are often chosen when they have good fundamentals but have fallen out of favor with the public due to a negative event. Value investors feel that company is undervalued but eventually will regain value. They also search for companies that have a solid business and are in the maturity stage of the business cycle. These companies often pay out large dividends and have brand reputation behind them so the stock is less volatile. This method takes longer on average to see profit however can be less risky (Growth vs. Value, 2007).

Jeremy Siegel, a professor at Wharton Business School, wrote a book entitled The Future for Investors: Why the Tried and True Triumph over the Bold and New in which he shows from his own research that for long term investing, value stocks are better and will reap greater returns.

Value vs. Growth investing should be done based upon the investor's future outlook. If it is short term, then greater profits should be seen through investing in high growth companies. For long term investing, value companies should provide the investor with greater profits due to their stability and dividends.

Large/Mid/Small Cap Stocks

People often look at the size of the companies they are thinking about investing in. Large Cap stocks are generally defined as a company that has a market capitalization over \$10 billion, Mid Caps have a market cap between \$2 and \$10 billion and Small Caps are under \$2 billion. John Bogle, the author of Common Sense on Mutual Funds, studied the returns of small cap vs. large cap stocks in between 1925 and 1997. He concluded that overall small cap stocks compounded annual return was 12.7%, trumping the large cap 11%. However, if you take out the 1973-1983 period where small cap stocks performed particularly well, large cap stocks were superior, with the small cap rate dropping to 10.4%.

Government Issued Securities

Many different governments, on all different levels (national, state, local), often issue securities which can be bought and held by investors. These normally are less risky than company issued securities but often higher rates of return are forfeited for that security. The US government issued securities which will be mainly discussed are considered 'risk less' investments due to the stability of the backing government.

Treasury Bills

Often referred to as T-Bills, these securities are issued in terms ranging for a few days to 26 weeks. They are sold a discount to their face value and upon reaching maturity; \$1000 will be paid per bill. These bills are excellent for short term investments because they can be bought and sold on secondary markets and often pay more interest than if money was left to sit in a brokerage account in cash (Treasury Direct, 2007).

Treasury Notes

Treasury Notes have maturities ranging from two to ten years and have a coupon that is paid biannually. They can be bought in denominations ranging from \$1,000 to \$1,000,000. The ten year note has become the benchmark when setting mortgage interest rates (Treasury Direct, 2007).

Treasury Bonds

Treasury Bonds have the longest maturity, from ten to thirty years. The coupon payment is every six months and the secondary market for these bonds is highly liquid which is good for investors who want to trade these (Treasury Direct, 2007).

Treasury Inflation-Protected Securities (TIPS)

TIPS are inflations-indexed bonds which were first issued in 1997. The principal is adjusted to the Consumer Price index, the most common measure of inflation. The coupon rate is constant but generates a different amount of interest when multiplied by the inflation adjusted principal. This helps an investor hedge against inflation.

TIPS are offered in five, ten, twenty and thirty year maturities (Treasury Direct, 2007).

Municipal Bonds

These bonds are issued by state and local governments. They are excellent for people in high tax brackets due to the income being tax exempt depending on where the bond was issued or for retired persons looking for a steady fixed income.

Foreign Government Issues

Although generally not for sale to US citizens, these foreign government bonds are worth taking a look at. Bond Funds that invest in these securities can be bought by US residents so they can share in the profits too. Most European countries bonds have an AAA rating so risk should not be worried about.

Mortgage Backed Securities (MBS)

MBS's are asset backed securities whose cash flows are backed by the principle and interest payments of a set of mortgage loans. The cash flows from this type of security are normally paid monthly. MBS's have recently become a more common investment so most are highly liquid thus increasing their appeal even more. Most are issued by the Government National Mortgage Association (Ginnie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). Ginnie Mae is backed fully by the US government so investors are guaranteed a timely payment. Freddie Mac has the special authority to borrow from the US Treasury so both are relatively low risk investments (SEC, 2007).

Real Estate Investment Trust (REITs)

A REIT is a company that invests in real estate and that has to pay out 90% of its taxable income to investors in the form of dividends. In 2005, there were over 200 REITs publicly traded in the US and that number has grown since then. They have a low correlation to other stocks and bonds which is good for diversification purposes and can be used to generate mid to long term income (National Association of REITs, 2007).

Developed Country Equity

Developed Country Equity can be describe as buying ownership, such as stock, in a company that is not the United States. The major developed countries include Canada, western European nations, Japan, and Australia. These overseas companies often post returns just as good as domestic securities but are less affected by US news thus helping to hedge the risk is ones portfolio.

Emerging Market Equity

Although Emerging Markets can be a risky position in the market, the growth and money making potential that they contain should not be overlooked by investors. An emerging market is defined as a country or group of countries that has the potential to experience strong growth in the upcoming years. Investing in these countries could be very profitable for investors however since they have no track record of past performance, it is extremely risky.

Different Securities to help with Diversification

There are many different groupings of stocks and assets available today that will greatly help the average investor diversify his portfolio. These groupings range from Exchange Traded Funds (ETFs) to actively managed Mutual Funds. Each group has its own benefits and detriments and invests in different areas of the economy so much research should be done before purchasing one. It is crucial to look at the underlying assets in each to make sure an area of investments is not bought twice.

Exchange Traded Funds (ETFs)

ETFs are open-end mutual funds with shares that trade like a stock. They can be purchased for every core asset class, including domestic equities, foreign developing and emerging equities, domestic bonds, inflation-index bonds, and real estate (Swensen, 336). ETFs are a great alternative to mutual funds do to their extremely low management fees (as low as .09% annually) and their liquidity in the secondary market. They offer a great range of diversification and make it much easier for the average investor to put money to work in different asset classes that would normally be inaccessible to him/her.

Index Funds

These funds mirror nationally acclaimed stock indexes such as the S&P500. When an investor buys into one of these funds they know exactly what they are

getting, a fund that tracks the movement of that index exactly. Using these funds lets investors get the diversification benefits of owning many different stocks without having to put out the millions of dollars that it would take to buy each one. However, it should be noted that these funds returns will be substantially lower than that the index performs do to the fees taken out. Index funds should be used to broaden ones exposure without taking huge risks (Mutual of America, 2007).

Actively Managed Funds

Actively managed funds have a portfolio manager or team that decides what stocks that fund will purchase. This has a distinct advantage over index funds because that manager can sell the funds position in certain stocks at the first sign of trouble rather than having to wait for the certain index to drop the stock. However, as time has shown, very few fund managers have been able to outperform indexes over long periods of time. The loads or fees that are involved with owning one of these funds is also high compared to other, less managed, funds so that will drive down profitability (Mutual of America, 2007).

Sector Funds

These funds invest their capital into a certain sector of the market. The eleven sectors of the market as defined by S&P are: utilities, consumer staples, transportation, technology, health care, financial, energy, consumer cyclicals, basic materials, capital goods, and communications services. By using sector funds in ones portfolio, the investor can better diversify his/her money across the different areas of

business. One form of investing in sector funds is through sector fund rotation. The goal of this strategy is to try and benefit from market upswings while getting out before its value decreases. People can use a number of approaches for this method. A Top-Down approach involves watching economic cycles for hints towards what industries will prosper. A Fundamental approach looks at the company's financial documents to see which industries are growing strongly and have P/E ratios that are at a discount to their growth. Finally, using Technical Analysis, investors look to the relative strength indicator for signals to buy or sell (Fidelity Investments, 2007).

Individual Stocks

Individual stocks can help investors be diversified into numerous sectors on a smaller scale without paying the loads of a mutual fund. They also can help investors control capitals gains with respect to their taxes. Individual stocks give investors a hands on approach to diversification by being able to choose their own, fundamentally stable, companies that could be held for either short or long term. It should be noted though that as a general rule, no more than 10% of a total portfolio should be invested into one company, even if it is the investor's employer.

Considerations of Diversification

The average investor does not understand how important diversification is for his/her portfolio. It can help to reduce risk while exposing the investor to more money making opportunities. There are many considerations that should be looked at when

deciding how to diversify. They include: investors age, the time frame for investments, the level of risk willing to be taken, and income level.

Investors Age

The age of an investor is important for determining how allocate their money in the markets. It is important to start as young as possible with investing when planning for retirement. Just to prove how important the time value of money is, please look at the following example.

An investor who is 19 starts a Roth IRA by contributing \$2,000 yearly until he is 26 years old. After that age, he stops contributing money and just manages the money until he is age 65. Assuming he can earn 10% on his money yearly, at age 65 his Roth will be worth \$1,035,148 when he only contributed a total of \$16,000!

Now another investor does not start contributing to his Roth IRA until he is age 27. From that point on until he is age 65 he will contribute \$2,000 yearly. Even though he puts \$76,000 into the account and earns that same 10% yearly, his portfolio at age 65 is worth \$883,185 (McKinley).

Because the first investor started 8 years earlier he had over \$200,000 more saved towards retirement. That is just one example that proves how important the time value of money can be.

Time Frame for Investments

All investors have different goals in mind when they put their money to work in the markets. Some have plans to retire in the near future while others are decades away from retiring. Many people invest in order to help pay for their child's college tuition. Every person needs their own diversification strategy depending on when they are going to need their money and how much they will need. Someone who is single and in their upper 20's or lower 30's may be more aggressive in their investments than someone in their 60's who is planning on retiring soon. People who have already retired look for securities which have a proven track record and that may pay out sizable dividends. They do not want to invest in high growth stocks where the risk of failure is imminent.

Level of Risk

The level of risk under taken on is also dependent on the age of investor and his/her level of income. If a person is very dependent on their investments to provide a steady stream of income then they may look into buying US treasury issuances or highly rated corporate bonds. On the other hand, a person investing for them self at a lower age may look into high growth companies for increased profit.

Income Level

How much money the investor makes each year can play a roll in deciding how to allocate the money. If the person needs a large amount of 'emergency' cash then it should either be kept in a savings account or an asset which is easy to liquidate unless they make enough monthly to suffice.

Suggested Asset Allocations for Age Groups

Using the above ideas, a method of diversification can be found for each individual. The following is a set of mock portfolio allocations of different portfolios for age groups. Let's first define the categories.

Stocks: Two thirds US stocks with a good smaller representation of small growth companies; One third international companies including emerging markets. Should include different funds to help with diversification

Bonds: Zero-coupon Treasury Bonds, no-load GNMA funds, or no-load high grade bond fund, some TIPS

Cash: Money Market fund or short term bond fund (average maturity 1 to 1 ½ years)

Real Estate: REITs or real estate funds

	Stocks	Bonds	Cash	Real Estate	Total Expected Return*
Mid 20's	65%	20%	5%	10%	9.41%
Late 30's Early 40's	55%	30%	5%	10%	8.81%
Mid 50's	45%	37 ½ %	5%	12 ½ %	8.33%
Late 60's and Beyond	25%	50%	10%	15%	7.26%

*The total expected return was calculated using a weighted portfolio model where the different asset values were taken from:

- Stocks: 1957-2003, S&P 500 Average Annual Return: ~11% (Siegel, 2005)
- Bonds: 1953-2003, T Bonds Average Annual Rate: 5.01% (Investment Tools, 2007)
- Cash: Lipper Money Market Average since inception: 5.09% (Calvert, 2007)
- REITs: Future expectations of 10% (Considine, 2007)

Diversification deals with the risk vs. reward trade off. Stocks carry the most risk while cash derivatives carry the least amount. As can be seen in the above spreadsheet, as someone progresses in age, they decrease the level of stocks they have in their portfolio and increase the levels safe securities such as bonds. This does cause a reduced level of profitability but also reduces their exposure to risk. Later in life, an individual cannot endure the same level of risk that 20 year old can.

Conclusion

Although it's impossible for one portfolio to fit the needs of all the investors, it's important to understand the different asset mixes that can be used to help one diversify. As the world continues to grow and globalization takes effect, the international markets will have more of an effect on the average investor's portfolio. This however is a good thing because those securities can offer increased profits for their holders along with more diversification. Equally important to diversification is planning ahead for retirement. There have been reports of problems with the Social Security system and in recent years pension funds have gone bankrupt. It is important for the individual to plan for his/her retirement and not rely on the government or companies to be there to support them in the future. This can be done from investing early in life with the right asset mixes. As long as the proper research is done and time is spent with devising ones portfolio, everyone can be on their way to a healthy retirement.

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