

## SIX STEPS TO AN EFFECTIVE ASSET ALLOCATION

### STEP 1

#### Define Your Goals

Just as important as what you're saving for is when you'll need the money. Whether your goal is short term (up to three years), intermediate term (three to 10 years) or long term (10 years or longer) you will need to balance the amount of risk you are willing to assume with an investment strategy designed to meet your goal. The longer your time horizon, the more you should lean towards equities to take advantage of the potential returns historically associated with stock investments. The shorter your time horizon, the more you will need to weight your allocation toward fixed and cash investments to avoid the short-term volatility associated with stocks. If your aim is building retirement security, it's important to remember that your time horizon extends far beyond the day you retire. Depending on when you retire, it is possible that your retirement will span 30 years or longer, which means your investments will need to keep working to provide future income and keep pace with inflation. Consider leaving some of your money invested in stocks, which provide the potential of growth to support your future needs.

### STEP 2

#### Gauge Your Risk Tolerance

With investing, your risk tolerance should be based on two factors: your time horizon (see Step 1) and your attitude toward investment volatility. For example, if you're not comfortable with the stock market's inevitable ups and downs, you may be inclined to weight your portfolio toward fixed-income investments such as bonds and money markets. The same holds true if you're pursuing a short-term goal—you can't afford to risk the money not being there when you need it. The further off your financial goal, the more risk you might be willing to assume by placing greater emphasis on equities; given the historically superior long-term performance. After all, a longer investment period will give you more time to make up for short-term losses. Also keep in mind that some equities are riskier than others. For example, narrowly focused funds that invest in small- or mid-size company stocks may have limited marketability and may be subject to more abrupt or erratic market movements than large-cap stocks.

### STEP 3

#### Find Products to Fit Your Profile

Mutual funds and annuities are automatically diversified since they invest in hundreds (or more) of securities at once. The inherent diversification makes them less volatile than a single investment within the same asset class. Yet funds are far from alike in the goals they pursue and the risks they assume. For example, an equity index fund may attempt to mirror the performance of a broad benchmark such as the Russell 3000® index by investing in practically every corner of the U.S. stock market. But many equity funds cast a far narrower net, raising the risk in the hope of greater potential rewards. As anyone who invested in technology funds from 2000 through 2002 knows, the level of diversification

may not be enough to protect you against the short-term risks associated with particular industries. Although one fund might provide a certain degree of diversification, it is important to balance your portfolio with investments from different asset classes. Consider diversifying within the same asset class by selecting investments with different goals and risks. Also, try not to overload your portfolio with overlapping types of investments—a scenario that could inadvertently increase your risk.

#### **STEP 4**

##### **Choose a Mix of Assets to Suit Your Needs**

Now that you've given some thought to the correlation between risk and return and considered your time horizons it's time to select the classes of investments best suited to the goals you're trying to achieve. Experts say that the way you distribute your funds among asset classes has more effect on your returns and success than the particular fund, account, or securities you choose.

(Remember, however, that diversification does not guarantee against losses.)

#### **STEP 5**

##### **Keep the Big Picture in View**

Try to diversify with an eye toward all your assets, including other tax-deferred retirement savings you may have such as an IRA; taxable securities you may hold through a brokerage, bank, or mutual fund company; bank savings and money market accounts; insurance policies; and even the value of your home. You want to look at your entire financial picture to set up the most efficient allocation strategy for your goals. Look for ways to create a better overall investment balance given your goals, risk tolerance and time horizon. And keep in mind, especially if you are young, that your most valuable asset may be your earning power, which should be protected with disability coverage and (if you have dependents) life insurance.

#### **STEP 6**

##### **Remember to Consider What's Overseas and in Real Estate**

Historically, the values of U.S. stocks and those of foreign companies often move at odds with each other. In the past few years, however, a variety of factors, including economic globalization and international corporate consolidation, have often caused the prices of domestic and foreign shares to move in tandem. Whether the recent trend is an anomaly or part of a new pattern remains to be seen. Although events around the world—and their effects on foreign markets—are unpredictable, it may still make sense to invest at least some of your money overseas. Global funds focus largely on foreign firms but also hold significant stakes in U.S. companies. International funds invest almost entirely beyond U.S. borders. (Be aware that there are special risks associated with investments in foreign securities, including erratic market conditions, economic and political instability, and fluctuations in currency exchange rates.) The real estate asset class also provides further diversification with investments that don't always move with the overall bond and stock markets. You can enhance the balance of your portfolio and further spread your risk across holdings.