Why Asset Allocation is vital to Successful Retirement Planning

So what will determine the quality of your retirement? Primarily, how well you set money aside for when you are no longer earning an income. Unfortunately, too many people think they've done enough by putting money into 401(k)s or IRAs. But that's just half the job.

To project and preserve what you'll have later, you also need to know how it will behave over time (and how it will be taxed when you take it out).

What you invest in is called an asset or "something of monetary value."

Your first task is to divide your money (or "allocate" it) among the three main asset classes found in most portfolios: stocks, bonds, and cash (and cash equivalents). This process is called asset allocation.

The combinations are endless, and a 50/50 allocation would mean 50% in stocks and 50% in bonds.

Asset classes react differently to events in the economy and to the passage of time. For example, when the stock market goes up, bonds will likely go down. And while cash (and cash equivalents) may not go up or down with the market, they can lose value over time due to inflation.

Your allocation choices will change with age. What works for you at one stage of your life won't likely work at another. For example, your needs and risks are different when you're a new parent than when you're getting ready to retire.

What Role Do Risk and Reward Play in Investment Decisions?

All investments carry some degree of risk, and you could lose some – or all – of your money by investing. Yet, some investments are riskier than others and could go up or down more easily.

Reward is what you get for putting your money in an asset, and the more risk you take, the more reward you could receive. And vice versa.

How Important Are Your Time Horizons and Risk Tolerance?

Time horizon is how much time you have left before reaching a specific goal, such as retirement or a house down payment.

Economies are affected by up-and-down cycles. If you're far from your target, you can take more risks because you have time to recuperate from a down cycle. But as you get closer, you'll take less risk, so you don't get caught with no time left to catch up.

Risk tolerance is a personal set point of how much risk you're comfortable taking on, following the "high risk equals high return; low risk equals low return" maxim. And that set point will change with your age.

An aggressive investor will have a high risk tolerance, comfortable with the idea of losing money in exchange for a chance at better results. The opposite is a conservative investor who is more interested in protecting the original funds than risking some loss to make a gain.

What Are Your Investment Options?

Besides dividing your money into those three primary asset classes, each class can be broken down into subclasses.

Stocks and bonds:

- Stocks and stock mutual funds
- Corporate and municipal bonds
- Bond mutual funds
- Lifecycle funds
- Exchange-traded funds
- Money market funds
- U.S. Treasury securities

Cash (and cash equivalents):

- Deposits in savings accounts
- CDs, or certificates of deposit
- Treasury bills
- Deposits in money market accounts
- Money market funds

Other asset classes exist, such as real estate, precious metals, commodities and private equity.

Stocks - Stocks can bring tremendous volatility, particularly in the short term, but they also offer the most significant potential for growth. But not all stocks are alike.

A stock's degree of risk can be influenced by factors such as a company's size and sector. Some are more appropriate for long-term investors who can ride out volatility. Others are more appropriate for someone nearing an investing goal, such as retirement.

Bonds - Bonds tend to be less volatile, but they also offer lower returns. As a result, they may provide a good way to preserve your money against losses from inflation over time, as long as the inflation rate is lower than the bond's return (or "yield"). As investors approach a financial goal, they tend to sell stocks and buy bonds to preserve the growth they have achieved.

The yields on bonds can differ with the sector they represent (federal or state governments, corporations, etc.).

Cash (and Cash Equivalents) – These assets don't necessarily react to market forces, but the value of the currency behind them does. While most are relatively safe investments, they offer the lowest reward.

Why Asset Allocation Is So Important

Each element in your portfolio plays a role in whether you meet your financial goals. And our increased life expectancy means we may be financing 20, 25 or 30 years in retirement.

But your investments could grow too slowly to meet your financial targets without the money growth that results from risk. And inflation could eat away your money's value if you take no risk at all.

Your chances of success are increased by first carefully allocating investments to multiple classes and then to various subclasses within each class.

That careful selection process is called diversification.

How to Make the Most of Your Investments

Investing may seem complicated because of today's financial information overload and the ever-growing number of choices.

But if you have a portfolio, start by examining your investment options within your 401(k)s and IRAs. Then continue until you have analyzed all the assets in your portfolio.

If you feel you want help setting guard rails for these many decisions, that could be the one decision that determines if you reach your various targets along your financial journey.

- Thomas J. Roberts
Principal & CEO

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Disclosures

All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value, and may trade at prices above or below the ETF's net asset value (NAV). Upon redemption, the value of fund shares may be worth more or less than their original cost. ETFs carry additional risks such as not being diversified, possible trading halts, and index tracking errors.

The principal value of a target fund is not guaranteed at any time, including at the target date. The target date is the approximate date when investors plan to start withdrawing their money.

Growth investments may be more volatile than other investments because they are more sensitive to investor perceptions of the issuing company's growth of earnings potential.

Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The fast price swings in commodities will result in significant volatility in an investor's holdings. Commodities include increased risks, such as political, economic, and currency instability, and may not be suitable for all investors.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

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