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The Sound Investor Series #13

Asset Allocation: A “Back to School” Project

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It’s Labor Day already and unfortunately summer is almost over. But it is also a time when we are invigorated by cooler days and looking forward to a fresh start. If you have been worried about your financial investments and want to get on the right track, here’s a great “back to school” project for you.

Asset allocation or how you divide your money between stocks, bonds and cash, is one of your most important investment decisions. And it is easy to see why, especially at the extremes. If over a 20 year period, one investor has 100% of their money in bonds and another has 100% in stocks, their returns are likely to be very different.

To make better decisions, it is critical to know how much of your money is invested in each asset class. And to do this you need to look at all your accounts together, not one account at a time. That means building a worksheet to combine all your investments so you can see the whole picture.

When working with clients, I build a simple spreadsheet to understand where their money is invested. (If you want a sample spreadsheet, please call or e-mail.) Down the left side, first list the asset classes. I put them in order of their risk - starting with the safest: cash and cash equivalents; bonds come next and stocks are last. At the end of each asset class put in a sub-total.

Within the bond section, I further segment the bonds and bond mutual funds by maturity (short-term, intermediate and long term). I also include an “Other Bonds” category to put bonds or funds I’m not sure about. It is important not to get bogged down and let the project come to a screeching halt if you are missing some information. Get everything on paper the best you can; and make it perfect later. It’s much better to get a ballpark understanding of where you are, then to throw your hands up in confusion and frustration.

Stocks and stock funds can be classified in many ways, but I think listing them by market capitalization (large, medium and small) makes the most sense. Make sure to also include an “Other Stocks” line for confusing stocks and mutual funds.

If you own balanced and/or Life-Cycle mutual funds, which hold both stocks and bonds; split the value between the “Other Bonds” and “Other Stocks” categories.

Now that we have listed all the assets down the side, put your different accounts along the top. Do not forget savings accounts, 401(k)s (yours and your spouse's), IRAs, brokerage accounts and mutual funds and annuities held outside your brokerage accounts. Under each account fill in how its money is invested.

After all the information is input, add a column where each line is added across so you can see how much is invested in each asset. For instance, if you had \$10,000 of bonds in your 401(k) and \$11,000 in your brokerage account, the total column would show \$21,000 in bonds.

The last step is to calculate a few percentages to help with the analysis. The most important is how your investments are split between bonds and stocks. So add the subtotals from your bonds and stocks together and see what percent of the assets are in each group. If your goal is to have 65% in stocks and 35% in bonds and you now see that only 55% is in stocks and 45% bonds, you need to rebalance your portfolio by selling some bonds and buying more stocks.

Now add in the cash you hold to the bonds and stocks to see what percent of your assets are in each of the three groups. Of course how much cash you hold, should be determined by your needs, not a target percentage of your portfolio. But it is still useful to see how large or small your cash position is relative to your whole portfolio.

The final percentages look at each asset class separately. So for just stocks, what percent are in Large cap, Small cap, International, etc. If 23% are in small cap stocks, are you happy with this allocation? Or should it be cut back after small caps have outperformed the market for the past 5 years? Note: if your "Other" category is large be careful drawing conclusions for this set of percentages.

In summary, asset allocation decisions are very important and will largely determine how your portfolio performs over time. At a minimum, every investor needs to know how their retirement savings are allocated between stocks and bonds. Investors must pay special attention to this and if you need help, call a broker or financial advisor today.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.

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