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Asset Allocation – Another Approach

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Asset allocation is one of the most important issues for investors. How they split their savings between stocks, bonds and cash will have a large impact on their long-term performance.

A simple example may help. Assume the stock market returns 10% and the bond market 5%. If an investor has 80% of their money in stocks and 20% in bonds they will make a total return of 9%. 8% comes from the stocks and 1% from the bonds. On the other hand, a very conservative investor may have 80% in bonds and 20% in stocks. Their total return is only 6% (4% from bonds and 2% from stocks).

Good asset allocation decisions require an understanding of risk and reward. When a person puts money into the market, they are purposely taking risk in order to receive a reward. Some commentators describe investing as “the process of buying risk.”

In efficient markets risk and reward go hand in hand. Investments with little risk are expected to have a small return. On the other hand, higher risks can lead to greater returns, but only if the risks are handled correctly.

Asset allocation is the process of determining how much risk you want to take with different parts of your savings. How much do you need for emergencies? Will you be spending your saving in the next ten years? How much can you commit to stocks, the highest risk and reward investment available to most investors.

There is no “correct” way to determine your asset allocation. Many methods use age as the primary variable with the reasoning being, as you get older, you are more likely to rely on your savings. Therefore, those assets should be in lower risk (and return) investments.

In general this makes some sense but it gets a little fuzzy for real investors. A better solution may result from analyzing assets and spending needs in the future.

The first step in everyone’s asset allocation process is to put money aside for emergencies. This money should be invested in safe products at the very short end of the fixed income market such as money market accounts and redeemable CDs. Since there is little risk, little return is expected and investors should only keep a small amount of their money here.

The next step is where Farm Creek's method differs. To figure your bond allocation we think investors should look at their remaining savings and figure out how much they will spend in the next 10 years. These funds should be invested in intermediate-term bonds.

Even if you are young and do not plan on spending any savings in the next 10 years, I still suggest putting 10% of your savings in bonds for diversification, just to be safer.

The rest of your savings, the money you do not think you will need for 10 years, should go into stocks. Stocks are high risk because they are highly volatile and move up and down a lot. The major risk to an investor from high volatility is that it increases the chance of buying the market too high or selling too low. High volatility also creates the potential reward of buying too low or selling too high.

The most effective tool for combating volatility is time. Investors who plan ahead and "have time on their hands" do the best. Investors who are not diversified and are forced to sell their stocks at a bad time lose the most. Taking one's time also means averaging in when buying and averaging out when selling.

Let's see how this might work in practice. A 40 year-old who doesn't expect to spend any retirement savings in the next 10 years, would keep 10% of his savings in bonds for safety and 90% in stocks.

A 55 year-old might need some of their savings in the next 10 years. Unexpected early retirement or medical bills may increase. It is very difficult to generalize on how an investor's allocation would look in percentage terms. The money that will be spent could consume a large percentage of one person's saving and be a more modest figure for a person with significant assets.

At 65, investors expect to use more money from their retirement saving over the next ten years and their asset allocation should reflect that. If an investor is following the advice that they can spend 4.5% of their savings per year, that comes to 45% in ten years. This 45% should be invested in bonds and the remaining 55% in stocks.

Obviously, if an investor is low on money and may need to spend all of it within 10 years, it should all be invested in bonds. Retirees with substantial assets on the other hand should keep a large chunk of their saving in stocks.

No one knows their "best" asset allocation until after the fact. So, look at the different methods and get a feel for a ballpark number that feels right. Avoid being too conservative as it will hurt you in the long term. And don't be too precise, decimal places are not needed and you should probably only use numbers that are multiples of 5.

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.