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The Sound Investor Series #75

“Family” Asset Allocation

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November 23, 2006

Thanksgiving is a wonderful holiday. And while we should be thankful everyday, it is nice to have a special day set aside to gather with family and friends and just appreciate our lives.

In most families there’s someone (like me) looking to spice up the dinner conversation by bringing up controversial topics – and if you need inspiration this year, mention inter-generational asset allocation around your holiday table. If you get past the initial stares without someone spilling the turnips in your lap, it is likely to be a spirited conversation.

Considering the big picture, inter-generational asset allocation is when a family works together to help each other and leverage the group’s financial assets. On the family level it might mean a middle aged couple encouraging their parents to be more aggressive investors and convincing them not to worry so much about potential short-term emergencies.

With everyone living longer many families will have three generations at the Thanksgiving Day table; grandparents, Baby Boomer parents and Generation X/Y children. A hundred years ago this whole family might be living under the same roof and their economic lives tightly entwined. Everyone would pool resources and elders would have the final decision on how money was spent.

Today, however, we go our independent ways and usually keep our finances very separate. Of course this makes sense and I am not advocating we turn the clock back. As we get older most of us want the freedom to spend our money as we see fit.

But even keeping our assets separate does not mean we can’t take steps to help the “whole” family. The most obvious place to cooperate is to “watch each other’s back.” If everyone is willing to work together there is no need for each individual to have as large a rainy day fund to cover a financial rough patch.

By implementing this strategy everyone’s cash holdings could be reduced. In addition the overall amount held in bonds can be cut resulting in more money invested in riskier, and hopefully higher returning assets such as stocks.

For illustration, let's imagine a family with a 78 year-old grandmother, 55 year-old parents and a 25 year-old daughter. The grandmother has \$100,000 and her investments are 15 percent in stocks, 60 percent in bonds and 25 percent in cash. The Boomer parents have \$60,000 with an allocation of 70/20/10 percent in stocks/bonds/cash. And the daughter has \$7,000 with 60 percent in stocks and 40 percent (\$2,800) in cash for emergencies.

Looking at this family's aggregate asset allocation reveals about 30 percent in stocks, 45 percent in bonds and 25 percent in cash. If this was a family under one-roof and sharing assets, this asset allocation would be very conservative.

A better approach might be for everyone to agree to help each other out if there are short-term problems. This would allow both the grandmother and the daughter to take more risk, while the parents would just be slightly more aggressive. If grandma moved to 60/25/15 percent for stocks/bonds/cash; the parents to 75/15/10; and their daughter to 80/0/20; the resulting family allocation would be about 66 percent stocks, 20 percent bonds and 14 percent cash.

The increased allocation to stocks would raise the "expected returns" of the portfolio quite substantially. Using conservative return assumptions of 8 percent for stocks, 5 percent for bonds and 2 percent for cash; the aggregation of the individual portfolios has an expected return of 5.1 percent. The more aggressive "family" portfolio has an expected return of 6.6 percent. The increase of 1.5 percentage points boosts the expected return by almost 30 percent.

Like all financial decisions, this idea needs thought and discussion before moving ahead. One important consideration should be how this might affect your immediate and extended family dynamics. For instance, it would be a really good idea to talk about this with your spouse before opening your mouth at dinner. If this strategy could lead to conflict within your own house or with family members becoming too involved in each others lives, it is obviously not a good idea. However, if it makes sense to everyone, it is probably worth serious deliberation.

If anyone takes me up on discussing this with their families I would be very interested to learn how the conversation worked out.

Happy Thanksgiving!

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