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The Sound Investor Series #3

Asset Allocation – What Is It and How to Do It!

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Asset allocation in its simplest form is the process of putting your money into different types of investments such as stocks, bonds, real estate and cash. (Cash means money in the bank or money market, not under your mattress.) Real estate is a major asset class and very important to many individuals, but since most of us buy it to put a roof over our heads, not as part of our regular financial planning, we will cover it separately at a later date.

Investors who divide their money between these investment groups in a thoughtful fashion will probably have higher returns and lower risk. But since no one knows the future and everyone's circumstances are different, there is no one right way. I will discuss one method for dividing your assets but be aware that asset allocation is part science and part art. Getting in the right ballpark is much more important than looking for exactly the right number.

In a previous column, we reviewed that stocks are riskier than cash or bonds, but in the long-term have better returns. With that in mind, investors should keep as much of their long-term investments in stocks as they can. What is considered long-term? A good rule of thumb is 10 years.

I find it useful to think of cash as emergency money, bonds as insurance and stocks as retirement money. Since we want to keep as much of our long-term investments as possible in stocks, let's begin by deciding how much to keep in cash and bonds.

First, fill the cash bucket for emergencies. The amount will depend on numerous factors including your health and job stability, but most professionals recommend between 3 and 9 months of expenses. Remember, your "cash" investments are very low risk and consequently, very low return so hold only enough to protect you in an emergency.

Second, fill the bond bucket. Here my method differs from traditional advice which suggests investors use their age to determine their bond allocation. A 30 year old investor would put 30% of their savings, after the cash portion, into bonds and the rest, 70% into stocks. Their asset allocation would be 70/30 (the standard convention is stock % followed by bond %). At 65, the asset allocation would be 35% stocks and 65% bonds. But we are living longer (thankfully) and the rule needs to be adjusted so that we hold more stocks for a longer period of time.

Rather than using your age, I suggest putting money you expect to spend in the next ten years into the bond bucket. If you are young, you probably will not need much of your saving for 10 years, but I would still put 10% into the bond bucket, just to be safe. This would result in an asset allocation of 90% stocks and 10% bonds. As you get into your 50s you may want to move more money into bonds, but probably not more than 20-30%.

At 65, if you are in good health an asset allocation of 50/50 may make sense. This is aggressive based on traditional rules, but people are living into their 90s. 65 year-olds need to have investment horizons of 25 or 30 years.

Investing in stocks and bonds; and holding some cash, diversifies your portfolio. This diversification lowers your risk because your investments are spread out and are exposed to different risks. Remember the advice not to keep all your “nest-eggs” in one basket.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This article is the third in a series on basic investment topics 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.

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