Step 9: Cover Your Assets

Description

As fun as finding winning stocks is (and trust us, it really *is* fun), your allocation to stocks (equities) is only one slice in your total investing pie. Asset allocation basically comes down to how much you should have in cash, how much in bonds, and how much in stocks. The Fool's four rules for asset allocation will help you slice up your portfolio into these important pieces.

Rule 1

If you need the money in the next year, it should be in cash.

You don't want the down payment for your vacation home to evaporate in a stock market — or bond market — crash. Keep it in a money market or savings account.

Rule 2

If you need the money in the next one to five years, choose safe, income-producing investments such as Government bonds, guaranteed investment certificates (GICs), or short, high quality corporate bonds.

Whether it's your kid's university money or the retirement income you'll need in the not-so-distant future, stay away from stocks.

As with all investments, risk and reward go hand-in-hand when it comes to "safe" assets. So, in order of "safest" to "still safe but technically riskier," we have Government notes and bills, GICs, and corporate bonds. That's also the order of lowest to highest yield.

As for corporate bonds, the general rule is to choose bond mutual funds over individual bonds if you have less than $25,000 to invest. However, keep in mind that bond funds can actually *lose* money as they do not have a set maturity date like an individual bond does. This can be awfully inconvenient if it happens right before you need it.

Stick with funds that focus on short- to intermediate-term bonds. And be vigilant about costs — you can find plenty of good funds with expense ratios below 0.50%.

Rule 3

Any money you don't need within the next five is a candidate for the stock market.

We Fools are fans of the stock market, and we know our history (with a little help from Ibbotson). Here's how stocks, bonds, and U.S. Treasuries have fared historically:

Geometric Mean Returns (1926 through 2011)

Asset Class	Average Annual Return
Large-Cap Stocks (U.S.)	9.8%
Long-Term Government Bonds	5.7%
U.S. Treasury Bills	3.6%

Of course, that's one long time frame, and in the short run, no one knows what stocks will do. But make no mistake: *Even if you're in or near retirement, a portion of your money should be invested for the long term*. That's because, according to the Centers for Disease Control, a 55-year-old can expect to live another 26 years. A 65-year-old has another 18 years ahead of her. The average 75-year-old lives into her late 80s. A 110-year-old, however, should sell everything and get to Vegas while he still can. (Kidding … sort of)

So unless you're a 95-year-old skydiver who smokes, expect your retirement to last two to three decades. To make sure your portfolio lasts that long, you should …

Rule 4

Always own stocks.

Over the long term, equities are the best way to ensure that your portfolio withstands inflation and your retirement spending.

According to Jeremy Siegel's *Stocks for the Long Run*, since 1802 stocks outperformed bonds in 69% of rolling five-year investing periods (1802-1807, 1803-1808, etc.). The percentage of the time that stocks whoop bonds only improves as you look over a longer horizon.

Holding Period	Stocks Outperform Bonds
3 Year	67%
5 Year	69%
10 Year	80%
30 Year	99%

Data from *Stocks for the Long Run*, by Jeremy Siegel.

For holding periods of 17 years or more, stocks have always beaten inflation, a claim bonds can't make.

The bottom line is that *when* you need your money will partially dictate *where* you put it. What else determines your asset allocation? That favourite term among financial gurus: your tolerance for risk.

Risk drives return

Most people base their investment strategies on the returns they want, but they have it backward. Instead, *focus on managing risk and accept the returns that go along with your tolerance for it*. It'd be great if we could get plump returns with no risk at all. But to achieve returns beyond a minimal level, we have to invest in things that involve some possibility that we'll lose money.

So ask yourself: What would you do if your portfolio dropped 10%, 20%, or 40% from its current level? Would it change your lifestyle? If you're retired, can you rely on other resources such as pension income, or would you have to go back to work (and how would you feel about that)? Your answers to those questions will lead you to your risk tolerance.

As an extra aid in determining your mix of stocks and bonds, consider the following table, from William Bernstein's *The Intelligent Asset Allocator*:

I can tolerate losing ___% of my portfolio in the course of earning higher returns	Recommended % of portfolio invested in stocks
35%	80%
30%	70%
25%	60%
20%	50%
15%	40%
10%	30%
5%	20%
0%	10%

So, according to Bernstein, if you can't stand seeing your portfolio drop 20% in value, then no more than 50% of your money should be in stocks. Sounds like a very good guideline to us.

OK, you now know how much you should have in stocks. But what kind of stocks — large caps, small caps, value, growth, international? And how much? We don't have thirteen steps here for nothing!

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