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#68 Allocate Assets at the Current Stage of Your Life

By Garry Good, MBA

Your investment mix should always reflect your financial objectives, time horizon, and risk tolerance. A well-designed portfolio has to be aggressive enough to achieve your financial goals while minimizing the risk of having to sell assets during a bear market.

Take this windmill analogy: Suppose you own a windmill that pumps water from a well. This windmill has two gears. In low gear, the mill rotates with even the slightest breeze — pumping 100 gallons of water every day — slow but steady, never more, never less. In high gear, the windmill pumps water at a much faster space — up to 1,000 gallons per day. However, running the pump in high gear takes a very stiff wind — the windmill may go days without pumping a single drop. Still, over an extended period of time, high gear can always be counted on to average at least 200 gallons per day.

Now consider the following scenarios:

- You have a 10,000 gallon tank available to collect and store water from your well. Which gear would you select to run your mill?
- Your storage tank holds only 500 gallons. Also, your essential water needs are a minimum of 100 gallons per day. Is it time to shift gears?

Just as you can select the gear that best matches your storage tank capacity, you have to select the asset mix to match your time horizon.

Like a pump in high gear, an aggressive asset allocation is unpredictable in the short-term but will deliver maximum output given adequate time. Like the large storage tank, time serves as the buffer against uncertainty. Lose this buffer, and you're left with no choice: You have to downshift into a slower, more reliable gear: a more-conservative investment allocation. This strategy tells you how and when to make the switch as you approach retirement.

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Decide When to Switch to a More Conservative Asset Allocation

How do you know when to start downshifting your portfolio? And how much change is required? Before answering, you have one more factor to consider: your tolerance for short-term risk. The next three sections cover aggressive, moderate, and conservative investors.

Aggressive investor

For an aggressive investor (with a high risk tolerance), a transition path for your portfolio may look something like Figure 68-1.

Upon retirement, you'll need a reliable income stream — something an aggressive portfolio isn't optimally designed to do. This calls for a less volatile asset mix, but you can't wait until retirement to flip the switch. Converting an aggressive portfolio into income-distribution mode takes a more extensive change. Start the transition early — ten years prior to retirement — to avoid forced selling of securities during a bear market. Keep in mind that market cycles sometimes last several years.

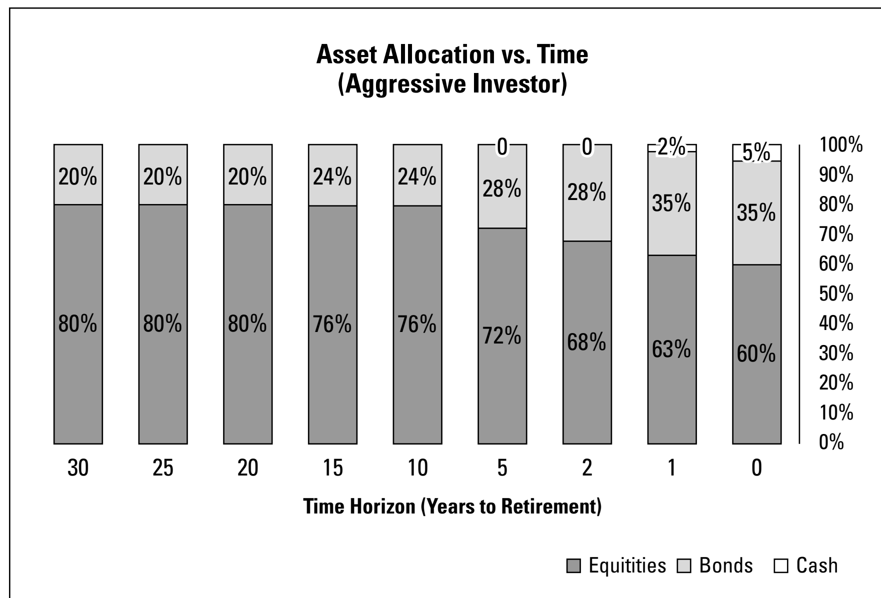

Figure 68-1: A more-drastic change within ten years of retirement.

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As you make this transition, note that your personal risk tolerance hasn't changed. You may be tempted to keep the throttle wide open with higher-risk investments; however, you have to let your time horizon trump your attitude about risk.

In the final stage of the process, you'll need to convert enough funds into cash-like instruments to cover retirement expenses over a one- or two-year period. This reserve may seem excessive, but it provides a buffer, giving you more control over when to liquidate assets for income.

Moderate investor

As a moderate investor, you can stomach a loss — within limits — but a more balanced portfolio helps you sleep better at night. After you've developed a moderate portfolio, your transition path to retirement should be a breeze. Compared to the aggressive investor, the required changes are less severe and can begin later. Remember — your risk tolerance has already reduced the volatility in your portfolio. Start the process five years before retiring, as Figure 68-2 illustrates.

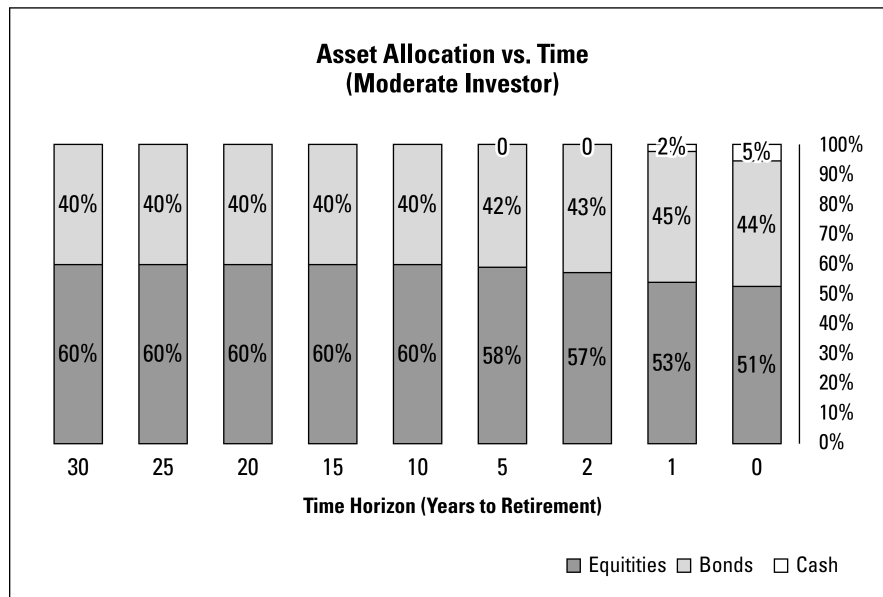

Figure 68-2: A fairly mild change within five years of retirement.

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Conservative investor

As the conservative investor, you enjoy watching the money flow while the market goes strong. Then the money stops coming in — and you go a while without. You begin to think, what if the money flow never starts up again? Do you need a different investment? Does this sound familiar? If so, you can't handle high gear! And your portfolio should look like Figure 68-3.

In this case, your risk tolerance takes precedence over time horizon as a controlling factor in your portfolio design. You may not even need to change the pace — you're already in first gear. There's absolutely nothing wrong with that. A portfolio that exceeds your risk tolerance is like an accident waiting to happen. During a bear market, you'll be pressured to sabotage your plan by selling off assets at precisely the wrong time.

A highly conservative asset allocation 30 years before retirement may make it impossible to amass enough wealth for a comfortable retirement. Make sure you have realistic expectations and that your investment returns will be adequate to achieve your goals. If not, you may be tempted to play catch-up and assume too much risk later on.

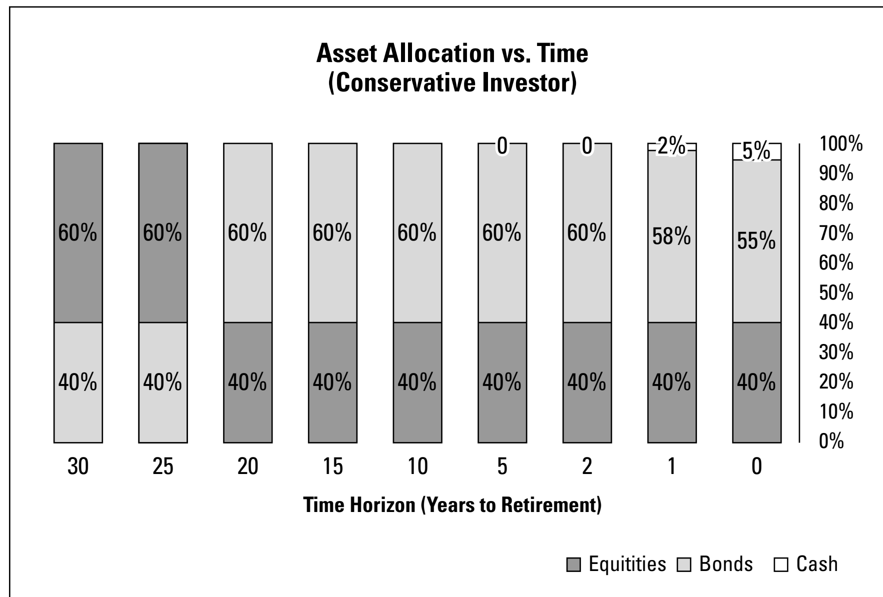

Figure 68-3: Conservative portfolios receive minimal adjustment.

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Transition to a More Conservative Asset Allocation

As soon as you have an appropriate transition path for your portfolio, you need a plan to manage the process. Here are some suggestions.

Use new contributions to revise the asset mix

If you're making significant contributions to your retirement savings, you can change your portfolio's asset allocation by simply applying a more conservative mix to all new investments.

Consider the following example: Your current age is 50, and you plan to retire in 15 years. You have $800,000 in current savings, 80 percent of which is equities ($640,000) and 20 percent of which is fixed income ($160,000). Your goal is to steadily transition your asset allocation to a 76-24 split in five years. Your annual contributions, including employer match, total $24,000 per year. The solution? Designate a 50-50 allocation to all new savings. In five years, your overall portfolio (ignoring growth) will stand at $700,000 equities (76 percent) and $220,000 fixed income (24 percent).

Modify your rebalancing plan

One way to change your asset allocation is to incorporate a shift in your asset mix while carrying out a typical portfolio rebalancing program. Normally, *rebalancing* involves swapping funds to restore a portfolio to your original asset allocation targets. Some investors may choose to rebalance on some regular basis — annually is usually sufficient.

Alternatively, you can establish a predetermined deviation trigger, which signals the need to rebalance. For example, if your desired mix is 60-40, you can opt to rebalance whenever your allocation in equities either exceeds 65 percent or falls below 55 percent.

Sometimes during a market decline, your portfolio may even self-adjust to a more conservative allocation. In this event, a corrective change may not be required and you can avoid selling equities during a down cycle. Conversely, you may see equity allocation increase during a period of market growth. This provides a win-win opportunity to benefit from market timing — you'll be selling appreciated stock to reduce your asset allocation below its prior level.

Strategy #77 names a rebalancing plan that can take you through retirement.