

October 2003 Commentary

Determining Your Asset Allocation

"If you don't know where you're going, you'll end up somewhere else."

Yogi Berra

The asset allocation decision may be the most important decision that any investor makes. Academic research shows that the proportion of stocks, bonds and cash is the most important factor in determining the variability of a portfolio. While many investors are led to believe that asset allocation accounts for 95% of investment returns, it doesn't determine your investment returns; rather, it is the primary determinant of risk or the potential volatility of your portfolio. Thus asset allocation is an effective tool for investors to use in managing risk. That's a good thing, too, because asset allocation is the *only* thing that an investor can directly influence.

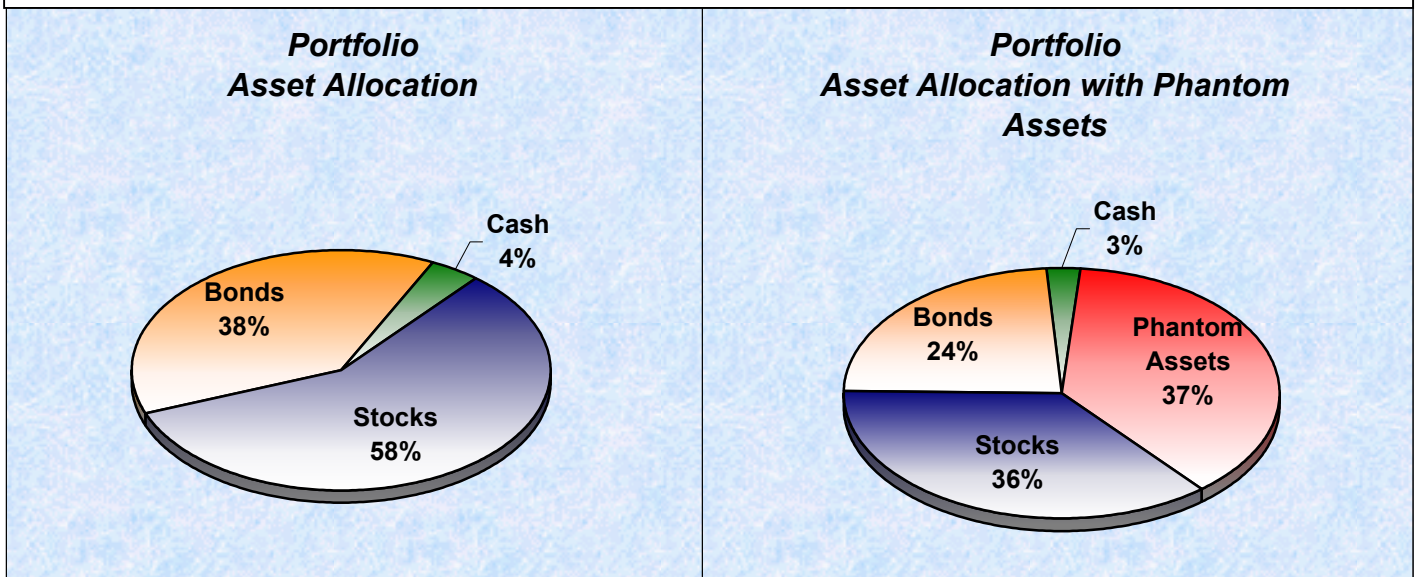
Of course, risk and return are inextricably intertwined. If you desire high returns, you will have to purchase volatile assets like stocks. The challenge that you face is determining how much of your portfolio to invest in stocks. To answer this question it is important to find out how much risk you can afford to take and how much risk you have to take to achieve your financial goals. Taking too much risk can prove to be disastrous as high short-term volatility can throw you off course, while taking too little risk can increase your odds of outliving your money. Neither situation is ideal. Your goal is to find a balance between less risky assets and riskier assets, allowing you to cope with both the short-term fluctuations and live without fear of outliving your savings. For some investors, there is a wide range of possible asset allocations that can reasonably be expected to deliver the results necessary to meet their goals, while other investors must operate in a much narrower range if they realistically hope to meet their goals.

In approaching asset allocation the first question to answer is: "What exactly are the assets we are trying to allocate?" The dollar value of stocks, bonds and cash is fairly easy to determine. But what about pension plan payments and Social Security? The cash flow from both of these income streams reflects phantom assets, assets that earn a return but do not belong to the recipient. While you cannot spend phantom assets all at once or pass them on to your heirs, phantom assets do produce life-long income and should be factored into your asset allocation.

The charts below show a sample portfolio asset allocation, with and without phantom assets, for a couple, age 60, who are about to retire. The stock portfolio accounts for 58% of their assets, bonds are 38% and cash is 4%. While this asset allocation doesn't look too different than the classic "60-40" allocation that many investors are led to believe is appropriate for someone about to retire, this couple is concerned that they might have too much of their portfolio in stocks. If we include the phantom assets (by capitalizing the cash flow from the pension plan and Social Security using an appropriate interest rate), the stock allocation shrinks to 36% while fixed income assets grow to 64% of the total. This new mix shows that the couple is invested more conservatively than they may think, and after further analysis, may not need to sell stocks to become more conservative.

"Take calculated risks. That is quite different from being rash."

George S. Patton



"Risk comes from not knowing what you are doing."

Warren Buffet

How do we at Madison help investors determine an appropriate asset allocation? Conventional wisdom says that younger investors can afford to take on more risk and as you grow older you should move to a more conservative asset allocation. While an investor's age is certainly a factor, our experience shows us that the combination of savings levels, portfolio value and retirement income versus retirement spending needs often proves to be more important in determining an appropriate asset allocation. For example, someone who has modest retirement spending needs can often afford to have a very conservative asset allocation independent of their age, whereas someone who would like to spend a great deal more in retirement is often required to invest more aggressively.

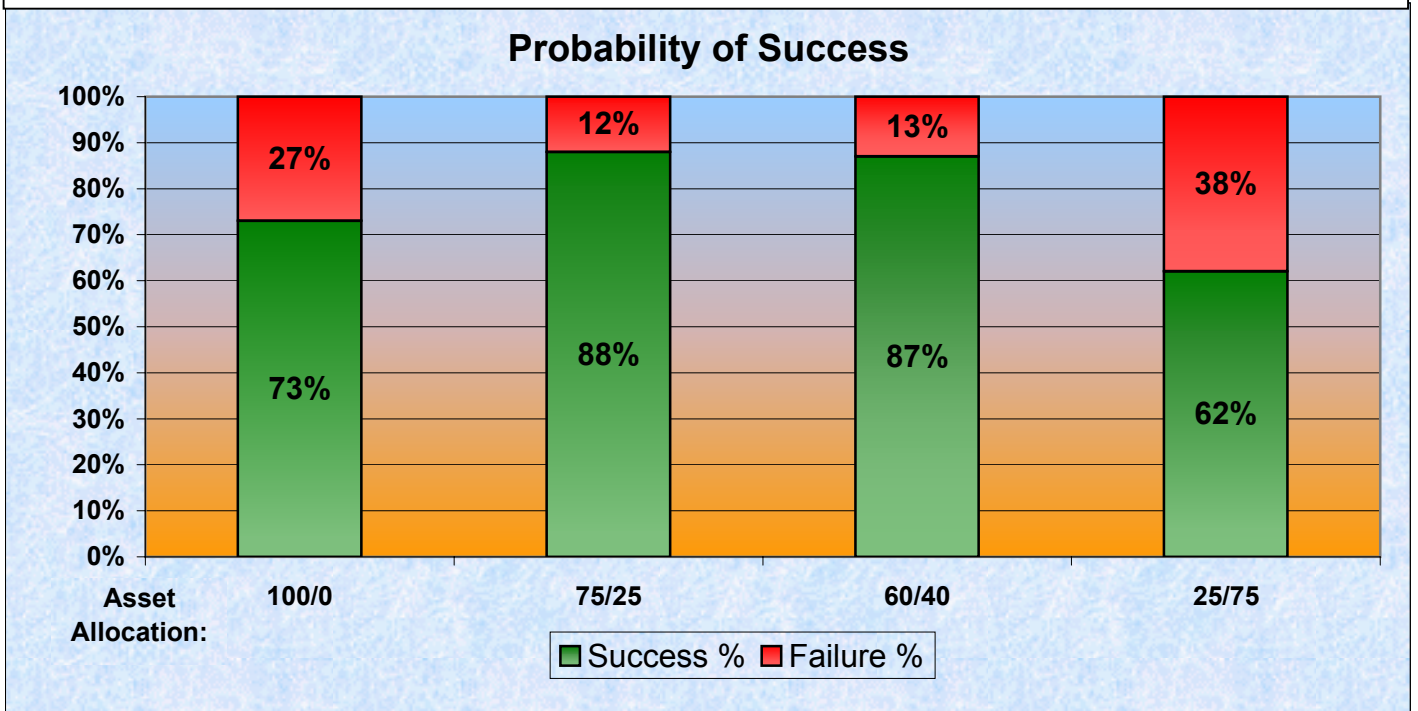
Thus, a good way to determine an appropriate asset allocation is to start writing down your financial goals. Can you answer questions like: How much do you wish to spend per year in retirement? When do you wish to retire? How much do you expect to spend on children's educational needs? How much of an estate would you like to leave to your family or to charity? When would you like to buy a vacation home and how much would you like to spend? There are many other questions, but here the focus is on your goals, not on how much you've saved or your perceived tolerance for risk.

The next step is to examine all of your financial resources (these include investment assets, financial assets and liabilities, your annual savings, pensions and other sources of income). At this point some financial modeling can be performed using various asset allocations. Madison examines a total of 1,000 different lifetimes, each with different investment results and investor mortalities. The results show the probability of achieving your financial goals (see below for a sample results chart of this analysis). The asset allocation that results in an acceptable level of probability is often the most suitable. In our sample chart, investing too much in stocks results in a lower chance of achieving financial success (73% probability) than a more moderate stock allocation (88% for the 72/25 allocation or 87% for the 60/40 allocation). At the other end of the spectrum, investing only 25% in stocks reduces the probability of success to only 62%. In this sample, the investor can select between a range of asset allocations that show a high probability of success (perhaps between the 75/25 and 60/40 allocations).

Since the future cannot be predicted, it is impossible to specify in advance what the best asset allocation will be. Rather, the focus should be on finding an asset allocation that will do reasonably well (generally one with a 75% to 90% probability of success) under a wide range of circumstances. This is why the process of examining 1,000 different return scenarios and lifetimes is so useful. Time and time again, the appropriate asset allocation will be determined not on your age, but on the probability of achieving your financial goals.

"Good plans shape good decisions. That's why good planning helps to make elusive dreams come true."

Lester R. Bittel



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