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INSIDE BUSINESS

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You Control Your Investment Destiny, Not the S&P 500 Nor The Dow

How much control do you have over your financial future? Given the recent drop of 3.7 percent in the Standard & Poor's 500 and 4.1 percent in the Dow Jones industrial average during the first two weeks of June, you may think that your financial future is out of your hands. In reality, a 1952 Nobel Prize winning study clearly demonstrated that asset allocation, and the subsequent changes to that asset allocation, accounts for over 90 percent of the total return in an investment portfolio.

Asset allocation determines what percentage of your investment portfolio is represented by equities, fixed income and cash. Within these broad categories, decisions need to be made regarding which asset classes will be utilized. For example equities have many classes such as large cap, mid-cap, small cap, domestic, international, growth and value. Once the appropriate asset classes are identified, the final step is to purchase the individual securities that represent the chosen asset classes.

What is the right allocation?

Ideally, the appropriate asset allocation is dictated by a clearly defined investment policy. Unfortunately, few individual investors have even heard the term investment policy, much less have one that is created for their specific situation. Before your portfolio is allocated between equities, fixed income and cash, an investment policy that fits your particular set of circumstances and risk tolerance needs to be established. Before the investment policy is crafted, certain questions need to answered, such as;

- What is the need for current income from these dollars?
- When will I need to access the principal (if ever)?
- What is my risk tolerance?
- Do I foresee any changes to my situation over next five years?

The benefit is of this process is the establishment of minimum and maximum limits for equity, fixed income and cash exposure. Without this structure in place, you are likely going to be shooting from the hip versus utilizing a disciplined approach to investing. The correct adjustments to your asset allocation will have more effect on your portfolio's performance than the choice of the specific securities that you own.

Change is the only constant

Your portfolio's ability to capitalize on appreciation while avoiding the downside of the market comes from the adjustments that you make to your portfolio within the established asset allocation parameters. The real questions are: What are the appropriate shifts to make and when should you make them?

For example, as the bond markets have recently produced higher yields in the short to intermediate portion of the yield curve and the equity markets have recently shown signs of uncertainty; what type of shifts in your asset allocation are appropriate? Your asset allocation is dynamic and needs to be responsive to changes in the market place. It needs to be reviewed on an ongoing basis.

Additionally, there are several variables that can cause your portfolio to fall out of compliance of its target allocation if not managed appropriately. For example, most mutual funds experience manager changes, investment style inconsistency and ongoing style drift. While mutual fund companies are required to disclose the changes annually when they release a prospectus, it is important to note that these changes typically occur throughout the year. Careful review of these changes directly translates into additional returns.

It is important that all of the securities in your portfolio are working together in unified fashion. A coordinated review will allow you to understand the impact that each mutual fund has on your portfolio. Too often, a portfolio will have unnecessary duplication of investments and typically there will be investments that are working against one another.

Be vigilant and diligent

Your asset allocation should be reviewed at least on a monthly basis to determine if your current mix of equities, fixed income and cash should be realigned. However, in the rapidly changing environment that we are experiencing a weekly review is more appropriate.

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