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Retirement Planning with Annuities: Asset Allocation

Asset allocation is a strategy that you can use to construct an investment portfolio. Asset allocation isn't about picking individual securities. Instead, you focus on broad categories of investments, mixing them together in the appropriate proportion to match your financial goals, the amount of time you have to invest, and your tolerance for risk.

The basics of asset allocation

The idea behind asset allocation is that because not all investments are alike, you can balance risk and potential return in your portfolio by spreading your investment dollars among different types of assets, such as stocks, bonds, and cash alternatives.

Different types of assets carry different levels of risk and potential for return, and may not respond to market forces in the same way at the same time. For instance, when the return of one asset type is declining, the return of another may be growing (though there are no guarantees). If you diversify by owning a variety of assets, a downturn in a single holding won't necessarily spell disaster for your entire portfolio.

Using asset allocation, you identify the asset classes that are appropriate for you and decide the percentage of your investment dollars that should be allocated to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives).

Asset allocation isn't about picking individual securities. Instead, you focus on broad categories of investments, mixing them together in the appropriate proportion to match your financial goals, the amount of time you have to invest, and your tolerance for risk. Asset allocation and diversification cannot guarantee a profit or insure against a loss. Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

The three major asset classes

Here's a look at the three major classes of assets you'll generally be considering when you use asset allocation.

Stocks: Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return than other investments, including bonds and cash alternatives. However, stocks are generally more volatile than bonds or cash alternatives. Investing in stocks may be appropriate if your investment goals are long-term.

Bonds: Historically less volatile than stocks, bonds do not provide as much opportunity for growth as stocks do. They are sensitive to interest rate changes; when interest rates rise, bond values tend to fall, and when interest rates fall, bond values tend to rise. Because bonds offer fixed interest payments at regular intervals, they may be appropriate if you want regular income from your investments. Bonds redeemed prior to maturity may be worth less than their original cost.

Cash alternatives: Cash alternatives (or short-term instruments) offer a lower potential for growth than other types of assets but are typically the least volatile. They are subject to inflation risk, the chance that returns won't outpace rising prices. They may provide easier access to funds than longer-term investments, and may be appropriate if your investment goals are short-term.

Not only can you diversify across asset classes by purchasing stocks, bonds, and cash alternatives, you can also diversify within a single asset class. For example, when investing in stocks, you can choose to invest in large companies that may be less risky than small companies. Or, you could choose to divide your investment dollars according to investment style, investing for growth or for value. Though the investment possibilities are limitless, your objective may always be the same: to diversify by choosing complementary investments that could help balance risk and reward within your portfolio.

Decide how to divide your assets

Your objective in using asset allocation is to construct a portfolio that could help provide you with the return on your investment you want without exposing you to more risk than you feel comfortable with. How long you have to invest is important, too, because the longer you have to invest, the more time you have to ride out market ups and downs.

When you're trying to construct a portfolio, you can use worksheets or interactive tools that help identify your investment objectives, your risk tolerance level, and your investment time horizon. These tools may also suggest model or sample allocations that strike a balance between risk and return, based on the information you provide.

For instance, if your investment goal is to save for your retirement over the next 20 years and you can tolerate a relatively high degree of market volatility, a model allocation might suggest that you put a large percentage of your investment dollars in stocks, and allocate a small percentage to bonds and cash alternatives. Of course, models are intended to serve only as general guides. You may want to work with a financial professional who can help you determine the appropriate allocation for your individual circumstances.

Build your portfolio

The next step is to choose investments for your portfolio that match your asset allocation strategy. If, like many other investors, you don't have the time, expertise, or capital to build a diversified portfolio of individual securities on your own, you may want to invest in mutual funds.

Depending on the mutual funds you choose, funds may offer diversification within an asset class, and if the fund is actively managed, the benefits of professional money management. Investments in each fund are usually chosen according to a specific objective, potentially making it easier to identify a fund or a group of funds that could meet your needs. For instance, some of the common terms you could see used to describe fund objectives are capital preservation, income (or current income), income and growth (or balanced), growth, and aggressive growth.

Pay attention to your portfolio

Once you've chosen your initial allocation, revisit your portfolio at least once a year (or more often if markets are experiencing greater short-term fluctuations). One reason to do this is to rebalance your portfolio. Because of market fluctuations, your portfolio may no longer reflect the initial allocation balance you chose. For instance, if the stock market has been performing well, eventually you could end up with a higher percentage of your investment dollars in stocks than you initially intended. To rebalance, you may want to shift funds from one asset class to another.

In some cases you may want to rethink your entire allocation strategy. If you're no longer comfortable with the same level of risk, your financial goals have changed, or you're getting close to the time when you'll need the money, you may need to change your asset mix.

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