Money Matters: Asset Allocation

Introduction

The purpose of utilizing an Asset Allocation strategy is to:

- Understand the trade-off between potential of gains and losses to your assets.
- Determine what level of risk/losses you are able to tolerate.
- Balance your portfolio to achieve the maximum performance possible while litigating volatility as much as possible.

Key to determining the an appropriate Asset Allocation is to understand your Retirement Timeline, Risk Tolerance, amount of assets available and the percentage of your assets you are willing to put at risk. It is common for people to over estimate their risk tolerance, this can be a major problem in a crisis where they end up selling investments at the worst possible moment (Panic selling) due to a major market downturn. Information covered in this discussion should help access your risk/tolerance and help identify what type of Asset Allocation should work for you.

It is important to re-assess your risk tolerance on a regular basis (1-5yrs) to determine if an adjustment of your asset allocation is in order. It is also important to re-evaluate your investments on a regular basis (yearly) and rebalance investments as needed to maintain the target asset allocation. Many investment brokers offer tools to the investor to help with this.

Disclaimers

- Financial information is by nature dynamic and ever changing, as a result you should assume any information presented here as dated and in need up update before any decisions should be made.
- Your situation is unique information provided here is general in nature tax many details may not be mentioned that may have impact on your financial situation. Make sure you investigate fully any topic that may be used to make a decision. Additionally, tax laws are complex and many times subject to vary based on the individuals income. Make sure you understand the implications for your situation.
- Calculations provided here are intended for ball-park estimates.

Key Terms

- (Strategic) **Asset Allocation -** The way you divide your money among major investment categories like stocks, bonds, cash and other types of investments, some of which are riskier than others. Therefore, this division into the various asset classes should be based on how much risk you're comfortable taking and how soon you'll need your money.
- **Diversification** – The process of investing in different types of investments *within* each asset class.
- **Risk Management** – The process of identification, analysis and acceptance or mitigation of uncertainty in investment decisions.
- **Tactical Asset Allocation** – Short term investment in holdings based on short term views of the markets. IE purchase of cruise ship stocks during a pandemic or an airline ETF for diversification on the expectation those stocks will rise in the short to mid-term to then be sold at a profit. This has many similarities with trying to time the market.

Rules of Thumb (that should be debunked)

- Based on age calculation (ie % stock should be 120 – your age)... See Case Study below.
- Estimated yearly average return should be 5-10%...Not when your not 100% vested in the market! 1-3% above inflation is more realistic, depending on your asset allocation.

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Considerations when determining assist allocation

- What is my risk tolerance? (Sleeping at night)
  - How much loss can I handle?
  - How much upside am I willing to miss out on? (Opportunity Risk)
- What amount of money do I want to secure of my retirement assets? (Ref Case Study)
  - How long until I retire?
  - How long do I want to be able to weather a down market?
    - Pandemic Crash (2020) **9 month** for DJIA to recover
    - Housing market crash (2007-2008) **5.4 years** for DJIA to recover
    - Dotcom Crash (2002-2015) **13.3 years** for NASDAQ to recover
- In retirement
  - How much money do I need each year?
  - What length of time will I plan for a down market

References

- Do Asset Allocation and Diversification Still Work? (09/05/2020)
- Calculator: How Should I Allocate my Assets?
- Does Your Risk Tolerance Change Over Time? (09/27/2018)
- Is It Time to Reassess Your Risk Tolerance? (09/24/2020)
- A Brief History of U.S. Bear Markets (09/22/2010)

Case Study (Ref Spreadsheet)

How to determine baseline (minimal) amount to have in secure funds to weather a bear market. Details on this and other strategies for retires is a topic of future discussion. See spreadsheet for calculations.

- How long do you expect the worst case scenario to last? Here we assume 10 years.
- Retirement Funds = $1,500,000
- Yearly cost of living = $60,000
  - 12% tax bracket
- Yearly Income SS = $30,000, Dividends = $5,000 ==> $35,000 (After Taxes)
- We need $25,000 of supplemental income from retirement accounts. How much will you actually need to withdraw to get the required amount? $28,409

$$\boldsymbol{W = \frac{N}{(1 - B)}}$$

    - Withdraw(*W*) = amount you need to pull from Retirement (We are solving for this)
    - Need(*N*) = Amount you need to live on ($25,000)
    - Bracket(*B*) = Your Tax Bracket (12% = 0.12 in this example)
  - For need of $25,000..... Withdraw = $25,000 / (1 - 0.12) = $28,409
  - $3,409 in taxes to be paid.
- Bear Market cushion = 10 yrs
- Secure funds requirement = 10yrs * $28,409 = $284,090

For $1,500,000 in retirement funds, baseline of at least 19% in Secure funds
For $3,000,000 in retirement funds, baseline of at least 9% in Secure funds
For $250,000 in retirement funds, 100% should be in Secure Funds

Target Date Funds

Target date funds offer to remove the burden of determining the proper asset allocation and making adjustments to their investments to maintain the target asset allocation off of the investor. This comes at a cost (management fees) and there is no guarantee these funds will deliver on their promises. Many funds did not meet expectations during the 2008 financial crises. While targeted funds seem to be getting better it is still the responsibility of the investor to understand the underlying philosophy and goals of the targeted fund since identical targeted date funds can perform very differently based on the managers investment strategy.

Target Date Funds performance in the 2008 crisis

Average Returns % by Morningstar U.S. Open-End Fund Category, through Aug. 31, 2009:

	12-month Return	2008	Annualized 3-Year Return	Annualized 5-Year Return
Retirement Income	-2.96	-17.74	0.47	2.57
Target Date 2000-2010	-5.64	-22.78	-0.44	2.38
Target Date 2011-2015	-9.70	-28.09	-1.91	2.16
Target Date 2016-2020	-9.78	-29.34	-2.00	2.71
Target Date 2021-2025	-13.26	-34.35	-3.37	2.40
Target Date 2026-2030	-14.07	-35.53	-3.82	2.13
Target Date 2031-2035	-14.90	-36.93	-4.06	2.28
Target Date 2036-2040	-15.60	-37.77	-4.51	2.15
Target Date 2041-2045	-15.85	-38.08	-4.45	2.47
Target Date 2050+	-15.87	-38.70	-4.64	2.27
Conservative Allocation	-3.22	-18.87	0.29	2.44
Convertible Bonds	-6.50	-33.45	-0.32	3.14
Moderate Allocation	-9.54	-27.94	-2.07	2.29
World Allocation	-10.80	-30.13	-1.07	4.52

Source: Morningstar, Inc.

Pros and Cons of target date funds

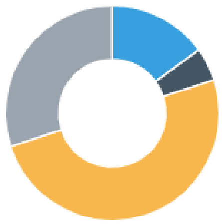
- Pros
  - Less likely to sell a target fund in a panic
  - Simplicity - Provides hassle free investments (Auto Rebalance and adjustments)
- Cons
  - Management Fees
  - May not be appropriate for your circumstance
  - Risk of throwing neglecting purpose of fund with investments external to fund.

References

- Target-Date Funds: Advantages and Disadvantages (08/21/2020)
- Is a Target-Date Fund the Best Choice? (11/06/2020)
- Calculator: How do expenses impact mutual fund returns?
- Target-date funds missed the target in 2008 (02/04/2009)
- How Target-Date Funds Fared Amidst the Coronavirus Sell-Off (04/06/2020)
- Morningstar's guide to target-date investing (05/14/2020)
- Throwing Darts at Target Funds (10/11/2007)
- Schwab: How to Pick a Target-Date Fund (09/24/2020)
- Schwab Intelligent Portfolios

Example Portfolios Asset Allocations

Conservative



Asset Class	Allocation
Large Cap Equity	15%
Small Cap Equity	0%
International Equity	5%
Fixed Income	50%
Cash Investments	30%
Other	0%

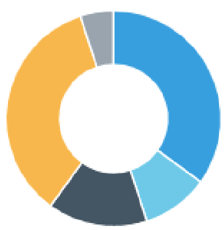
Time Horizon: Under 3-5 years

- Want current income and stability
- Not concerned about increasing the value of your investments

Return: (1970-12/2019)

- Average Annual Return: 7.4%
- Best Year: 22.8%
- Worst Year: -4.6%

Moderate



Asset Class	Allocation
Large Cap Equity	35%
Small Cap Equity	10%
International Equity	15%
Fixed Income	35%
Cash Investments	5%
Other	0%

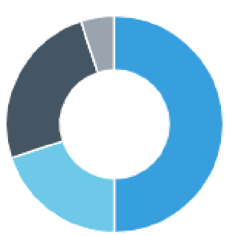
Time Horizon: Around 10 years

- Want solid growth with relative stability
- Current income is not the only goal
- Can tolerate some fluctuations but considerably less than overall stock market

Return: (1970-12/2019)

- Average Annual Return: 9.4%
- Best Year: 30.9%
- Worst Year: -20.9%

Aggressive



Asset Class	Allocation
Large Cap Equity	50%
Small Cap Equity	20%
International Equity	25%
Fixed Income	0%
Cash Investments	5%
Other	0%

Time Horizon: More than 15 years

- Most concerned about investments growing in value
- Don't need current income
- Have a good tolerance for risk

Return: (1970-12/2019)

- Average Annual Return: 10.2%
- Best Year: 39.9%
- Worst Year: -36.0%

References

- Schwab:
    - What's in Your Portfolio? The Role of Various Asset Classes (07/31/2020)
    - Ways to Help Reduce Risk in Your Portfolio (02/28/2020)
    - Stocks in Retirement: You Might Need More Than You Think (02/24/2020)
    - Why Global Diversification Matters (11/13/2019)
    - Is Your Portfolio Truly Diversified? (1/20/2018)
    - What's the Best Way to Rebalance Your Portfolio? (01/17/2018)
    - Structuring Your Retirement Portfolio (10/25/2017)
    - Nearing Retirement? Assess Downside Risk, Upside Potential (08/05/2016)
- Kiplinger
    - Asset Allocation
    - *Best ETFs for Your Investment Portfolios (08/01/2019)
    - The Kiplinger ETF 20 – Our Favorite Exchange-Traded Funds for Every Investor (12/31/2020)
    - The 5 Best iShares ETFs for a Core Portolio (09/18/2020)
    - The 7 Best ETFs for Retirement Investors (10/14/2019)
    - You Need an Asset Allocation Plan Even More in a Bull Market (12/31/2019)
    - Getting the Best Financial Advice (10/30/2008)