

What Is Asset Allocation?

Lewis Carroll, the author of *Alice's Adventures in Wonderland*, once said, "If you don't know where you're going, any road will get you there." This is certainly true when it comes to investing: If you don't know where you're headed financially, then it is not as vital which investments make up your portfolio. If you do have a monetary destination in mind, then asset allocation becomes very important.

The term "asset allocation" is often tossed around in discussions of investing. But what exactly is it? Simply put, asset allocation is about not putting all your eggs in one basket. More formally, it is a systematic approach to diversification that may help you determine the most efficient mix of assets based on your risk tolerance and time horizon.

Asset allocation seeks to manage investment risk by diversifying a portfolio among the major asset classes, such as stocks, bonds, and cash alternatives. Each asset class has a different level of risk and potential return. At any given time, while one asset category may be increasing in value, another may be decreasing in value. Diversification is a method to help manage investment risk. Asset allocation and diversification do not guarantee a profit nor protect against loss. So if the value of one asset class or security drops, the other asset classes or securities may help cushion the blow.

Dividing your investments in this way may help you ride out market fluctuations and protect your portfolio from a major loss in any one asset class. Of course, it is also important to understand the risk versus return tradeoff. Generally, the greater the potential return of an investment, the greater the risk.

As a result, the makeup of a portfolio should be based on your risk tolerance. Generally, you should not place all your assets in those categories that have the highest potential for gain if you are concerned about the prospect of a loss. It is essential to find a balance of asset classes with the highest potential return for your risk profile.

Other factors that are important to developing an asset allocation strategy are your investment goals and time horizon. When you are considering how to diversify your portfolio, ask yourself what you want to accomplish with your investments. Are you planning to buy a new car or house soon? Do you aspire to pay for your children's college education? When retirement rolls around, would you like to travel and buy a vacation home? These factors should all be considered when outlining an asset allocation strategy.

If you require a specific amount of money at a point in the near future, you might want to consider a strategy that involves less risk. On the other hand, if you are saving for retirement and have several years until you will need the funds, you might be able to invest for greater growth potential, although this will also involve greater risks.

Whichever asset allocation scenario you decide on, it's important to remember that there is no one strategy that fits every type of investor. Your specific situation calls for a specific approach with which you are comfortable and one that could help you pursue your investment goals.

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