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Asset Allocation in a Nutshell

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For those unfamiliar with the term, asset allocation is an investment strategy that aims to control risks and returns within a portfolio of assets by apportioning those assets in a certain manner relative to each other. Most investment professionals agree that asset allocation is one of the most important decisions any investor makes, because it is the primary determinant of the long-term return of a portfolio. Factors like security selection and market timing pale in comparison to the predominance of asset allocation in influencing investment outcomes.

The three main asset classes we tend to utilise are equities (also known as stocks or shares), bonds (also known as fixed income), and cash and cash equivalents. These three asset classes have different levels of risk and return, so each will behave differently over time. Equities have the highest average return over time of the three, but also the highest volatility, which is a measure of risk. In fact, it is quite common for equity investors to experience at least double the volatility of bond investors.

On the contrary, cash hardly fluctuates but is low-yielding and sometimes does not even return enough to counter inflation.

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A fundamental rationale for doing asset allocation is that different asset classes offer non-correlated returns (or at least lowly correlated returns), hence diversifying among them reduces the overall risk in terms of the variability of returns for a given level of expected return. For those who are mathematically inclined, if you plot returns against risks for every single combination of, say, equities and bonds (100% equities, 99% equities & 1% bonds, 98% equities & 2% bonds, etc.), you will get a curve that is known as the "efficient frontier". Being on that curve will mean the most optimal allocation for a certain risk-return requirement.

Asset allocation should be tailored according to an individual's financial goals, risk tolerance, life stage and investment horizon. It should therefore come as no surprise that there isn't a "one-size-fits all" solution or a simple formula to determine one's ideal asset allocation.

A starting point is doing an honest assessment of one's risk tolerance. If a person is naturally risk-averse, then his or her portfolio should not be overly weighted towards equities. However, if this person is young and has a rather ambitious financial objective, then a conservative portfolio may not return enough over time to meet this objective. On the other hand, someone nearing retirement who has almost amassed his nest egg for a comfortable retirement will not need to accept much risk even though he might be a natural risk-taker. These simple illustrations show the importance of having a good financial adviser who can take into account all the considerations before deriving an asset allocation appropriate for a person's ability and risk appetite.

Financial advisers should be supported by investment professionals who take historical risk-return profiles of asset classes and perform back-testing on blended portfolios. The primary responsibility of the financial adviser is then to ascertain the right risk-return trade-off for a person given his current financial situation, aspirations and risk appetite, and match it to the asset allocation that can deliver this based on historical performance.

Further to this is the allocation to sub-asset classes, such as large cap versus small cap stocks, corporate versus government bonds, etc. Other asset classes for the consideration of more sophisticated investors include property, commodities, currency, and so on.

For those just starting out in investments and asset allocation, a simplistic approach is to use one's age as a guide. If you are young, you have the luxury of time on your side, so you can afford to load up on higher-risk-higher-return asset classes such as equities. As you get older, tune your portfolio to gain more and more access to bonds. It has been said by some that one's age is a good indicator of the bond allocation (in percentage terms) one should have in a portfolio. Bear in mind that this is a very rough guide. The best approach is to seek the help of a competent financial adviser to get your asset allocation right, the first time.

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