Make a New Year's Resolution to work on your asset allocation

Contributed by Henry To, CFA
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Asset allocation is as important to your financial health as regular medical checkups and dentist visits are to your physical health.

As the title of this commentary implies, we are hear to discuss asset allocation for 2007 – and even beyond. It is amazing to me that most of the general population can spend 40 hours a week toiling away in their jobs but don't set aside some time each quarter to determine their asset allocations – whether it is in their taxable savings or in tax-deferred retirement accounts such as a 401(k), 403(b), or an IRA account (sorry, but I am only the U.S. terms here). I realize that this may not be the best way to spend half a Sunday, but saving for retirement and allocating your assets appropriately is imperative for a comfortable retirement – and collectively, is a decision that is just as important as a decision to buying your primary home and finding and marrying the right partner.

For those who spend time on investments (and by definition, those that are reading this commentary is either serious about their investments or even treat investing as a hobby), let us be clear and tell you this: If you are like most Americans or mutual fund managers, your asset allocation (how much of your assets should be placed in domestic equities, international equities, bonds, cash, and so forth) is typically the primary determinant of your future returns. Picking individual stocks isn't for everyone – especially in this day and age when nearly half of the revenues in the S&P 500 components are from overseas markets (thus requiring much more research than ever before) in a market that is dominated by nearly 10,000 hedge funds.

Before you actually determine what your asset allocation should be, you should ask yourself some questions, such as the following:
- What is your overall objective? Is it to provide for retirement? Besides retirement, do you also want to fund the cost of college for your grandkids?
- What is your investment horizon? Do you need current income to support retirement?
- What is your risk tolerance? In other words, what kind of portfolio would allow you to sleep soundly at night? What would you do if your equity portfolio goes down by 20% in 2007? Will you liquidate or rebalance (i.e. sell some bonds and buy more stocks after the decline)?
- Do you have any restrictions as to what you can invest? For example, do you prefer to avoid tobacco and alcohol stocks? If so, then you will need to opt for socially-responsible mutual funds instead.

For those subscribers who have not had a chance to work on their asset allocations (it should be noted that a proportionally high amount of funds in 401(k)s are invested in money market funds, especially after the 2000 to 2002 bear market), I encourage you to make it a priority next year. Or better yet, make this as one of your New Year's resolutions. For many subscribers, it may just be as simple as finding three or four different fund vehicles and then allocate your money between them in the appropriate manner. The aim is to find low-cost, simplistic, low-turnover, stable, funds with broad diversification and representation of the investable universe. Based on my experience, the Vanguard fund family fits this bill perfectly.

Founded in 1975 by John Bogle, Vanguard has a great reputation and is one of the few mutual fund families known for its bastion of integrity (the 2003 mutual fund timing scandals notwithstanding, even American Funds – owned by Capital Research – has been investigated by both the SEC and the California Attorney General for making payments to brokers that give it preferential treatment). It was the first to create an S&P 500 index fund catered to retail investors (1976), a bond index fund for retail investors (1986), and an international stock index fund (1990). Today, the Vanguard Fund Family has 114 individual funds (including fund of funds and lifestyle funds) with an average expense ratio of only 0.25%. It also has one of the lowest turnover percentages as a group in the mutual fund industry as well as the most simplistic structure – most of its mutual funds have only two classes of shares, whereas many mutual fund families have five or more classes with many different expense and load structures.

For the simple investor, the three fund structure (consisting of only the Vanguard Total Bond Market Index Fund, the Vanguard Total Stock Market Index Fund, and the Vanguard Total International Stock Index Fund) as advocated by the following WSJ article with periodic rebalancing to adjust for changing time horizon or risk tolerance makes the most sense. If one has zero time to focus on investments, then it may even make more sense invest in a certain LifeStyle or Target-Date fund in the Vanguard Fund Family. For myself – if I do choose to go the mutual fund route – then instead of picking only three, I will pick six to eight different funds from the Vanguard Fund Family and adjust periodically to reflect my changing preferences for large caps vs. small caps, European stocks vs. Pacific stocks, and so forth. For over 95% of retail investors, I do not advocate trying your luck at allocating your money between the different sector funds. Not even most professionals can master such a strategy as to be able to beat the indices.