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Constructing Your Investment Portfolio

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Attempting to manage your own financial portfolio and investments can be an overwhelming task, especially when you are depending on it for your well being in retirement. You may begin to think to yourself: Am I doing it right? Did I invest in the right things? Did I do the correct analysis? Will my investments survive the market? Many times, it is hard to tell, especially when you are trying to plan ten or twenty years in the future. This article will introduce some key concepts that are fundamental in a successful portfolio creation.

Asset Allocation:

Asset Allocation involves an investment strategy aimed to balance risk and reward by apportioning a portfolio's assets according to an individual's goals, risk tolerance, and investment horizon. This sounds complex, so let's break it down.

Typical investment portfolios consist of three main asset categories. We will start off with stocks and bonds. In a "typical" market portfolio, these two security types are negatively correlated, meaning when one rises, usually, the other one falls. When this happens, the average return in the overall portfolio is the combination of these performances, but the overall risk is less because they tend to offset one another - the basic concept of risk vs return. The more stocks you have, the more growth and return potential. The more bonds or fixed income, the less risk, and more stability you'll have. Finally, the third main security type is cash or cash-equivalents. Cash or money market funds are assets that hold relatively no risk but are highly liquid for times you may need access to cash; they also add further stability to your portfolio.

Asset allocation is all about finding the right percentages of stocks, bonds, and cash that fit your financial situation, time horizons, and risk tolerance. An example of just one investment portfolio would be one with a 70/30 asset allocation - 70% stocks, 30% bonds, and usually 1-2% cash as well. However, this is not a cookie cutter allocation that everyone should use because each individual's financial situation is different. This is step one, figuring out how many slices you want in your investment pie and how big (what percentage) each slice should be.

Diversification

Asset allocation is an excellent first step to a solid portfolio foundation. The next step is diversification, which helps determine the various asset sub-classes or economic sectors that will be represented within each asset class (stocks, bonds, cash). An example of a sub-class for stocks may include large, mid, small, or international company stocks. These are all considered stocks but now we are talking about different types of stocks. These categories can be divided even further and broken down by economic sectors such as basic materials, health care, energy, technology, etc. If you invest in bonds in your portfolio, what might these sub-classes look like? Well, bond types may include municipal, corporate, or government bonds, and they can further be broken down by length (maturity) and credit risk.

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The ultimate decision of which asset classes and sub-classes to choose must be made by the investor. A younger investor looking for growth may decide they want mostly stocks in their portfolio, and even more specifically they could want riskier types of stocks, for example, small-cap stocks in the technology sector. Why are these riskier? Small-cap stocks are those of small companies who, often, have very high growth potential but carry more risk. The technology sector is considered a high growth sector as well, meaning more return and therefore, more risk. An older investor who wants to preserve their assets might want 50% stocks and 50% bonds. The stocks they choose will likely be quite different when compared to the growth seeking investor. Someone with a lower risk tolerance would invest in well-established, large-cap stocks with a history of good returns and dividends. The 50% bond allocation creates higher stability in the market due to their lower overall risk as well. Even though this portfolio is half invested in stocks, by selecting certain asset types, the investor may be able to lower risk. This is step two: determine which asset sub-classes (types of stocks and bonds) are best for your individual financial situation.

Security Selection:

The last and final step is the individual security selection. At this point, individual securities, mutual funds, ETFs, or bonds are usually chosen so that they fit into each of the portfolio's allocated asset classes. You may have decided that you want 60% in stocks comprised of international and large-cap stocks. Now you must find individual securities that will fall into this category. Many times, this can be the most complicated and time-consuming part. This is where fundamental research comes into play involving analyzing which stocks, mutual funds, or bonds have the most promise within a sector you want exposure to. But do not fret, many studies show that overall asset allocation (giving specific percentages to your stock and bond percentages) is much more important than the individual securities that make up that allocation. Nonetheless, this would be considered the third, and final step, completing the creation of your portfolio and following decisions made in the first two steps.

Proper portfolio construction is both an art and a science. As with all things financial, there is no single solution for all. Each individual investor must consider their assets and goals in order to make the determination of the best allocation for them. Understand that stocks increase returns and have higher risk, and that bonds have lower risk but also lower returns. In regards to where to start, think about the big picture first; what percentage in stocks/bonds/cash fits for you? 100% stocks? 80% stocks with 20% bonds, 50%/50%? Then narrow it down and determine what types of assets you want for each of these allocations. Lastly, choose individual securities that will fit into these selections.

In a recent study, it was found that asset allocation accounts for 91.5% of the success in a portfolio. Let me say that again: 91.5% of a successful portfolio is due to proper asset allocation. Individual security selection accounts for 4.6% of a successful portfolio and market timing, only 1.6%. If you build your portfolio foundation around your allocations in stocks, bonds, and cash you are well on your way to building what may become an effective portfolio. Take a look at your existing investments with this in mind to help determine if you should make any adjustments. It's never too late to build a successful portfolio.

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