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## The Power and Peril of Asset Allocation

Much has been made of asset allocation over the years. So much so that by now most people know that they should own a variety of securities in their portfolio.

At the simplest level, asset allocation dictates that investors should hold some stocks and some bonds - as one tends to zig while the other zags. More complex strategies certainly exist, and these may include international securities and more obscure investments in addition to stocks and bonds.

Stocks are typically more risky, or volatile, than bonds are. Therefore, it's obvious to most people that as you add stocks you increase risk and as you subtract stocks, risk is decreased. Given the relationship between risk and return, more stocks typically means greater long-term expected returns, and vice versa.

While we all know it's important to have stocks and bonds in our portfolios, whether our current mix is right for us is much harder to gauge. Anyone could tell you it's critical to have the right mix, but how do you arrive at a blend that is just right?

One method you could try is to follow the old maxim that your stock allocation should be one hundred minus your age. Which, in the case of a forty year old, would equal a portfolio that is 60% stocks and 40% bonds. For this individual this rule of thumb could be a perfect proxy for their required allocation, but it is more likely to be inaccurate as it considers one factor and one factor only, age.

Nowhere does this rule allow for any additional information to alter the allocation. In our opinion, that is a very incomplete picture of the investor's willingness, desire and ability to take on risk - not to mention it says nothing of the ability of such a portfolio to achieve the investor's desired goals.

There are a number of questionnaires available, both online and in print, that try to provide an optimal asset allocation based on your answers to probing questions, but even they differ in the answers they provide and their levels of sophistication.

Not only is identifying the optimal asset allocation a challenge, once you do (or think you do) it is often difficult to understand what you picked and why. With risk and return metrics often explained in jargon and not in plain English, you may be left scratching your head wondering what on earth standard deviation is and whether your expected standard deviation is good or if it should be higher or lower.

At Investment Counsel we try to limit the jargon whenever possible and take these abstract concepts and turn them into something we can all understand - simple dollars and cents. By phrasing asset allocations in terms of possible gains and losses these numbers become more meaningful to investors.

Additionally, knowing how investors react to such information is also insightful into how they would act if the market turned sharply downward. It certainly is an improvement over simply classifying someone on the aggressive to


INVESTMENT COUNSEL INC.

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5225 East Cook Rd • Grand Blanc, MI 48439 • (800) 689-7897 • www.Invest-Counsel.com

conservative spectrum. Let's take a look at some examples of questions we may ask to determine your appropriate asset allocation:

> If you invested $100,000 in an investment we'll call Portfolio A and over a 1-year period you could make up to $5,930 how would you feel about your investment? What if you stood to lose up to $1,640 during that year instead?*
>
> If, using the same $100,000, you instead invested in Portfolio B, which could have grown as much as $19,210 during the year or could also have declined by $10,200 would you prefer this option to the first?*
>
> Perhaps you chose Portfolio C, which using the same initial investment, could grow to as much as $42,290 in one year or drop by as much as $36,390 by the end of the period. How does this option stack up to the others in your mind?*

Using dollar and cents examples like these helps investors better visualize what potential upsides, and more importantly, potential downsides are to their investment choices.

Equally important would be a follow up query regarding their actions at the end of the year. Most specifically, if the portfolio you chose happened to have a negative outcome during the year how would you react? Would you keep calm, be angry/disappointed and would your feelings dictate your actions after the loss? In other words would you sell the investment, continue to hold it, or decide to buy more of it.

When building portfolios, understanding the terminology is great, but understanding how it impacts your account and how you are likely to respond to it is much more important. The only way to get to each investors ideal allocation is to ask the right probing questions and get to know the client. This is something that a robo-advisor or simple questionnaire simply cannot do.

Taking a concept that is rooted deep in academia and theory and translating it into easy-to-understand language, which ultimately helps us better work with you and make better decisions on your behalf, is the core of what Investment Counsel does. Only with the proper insights can you release the full power of asset allocation.

We believe our approach better matches investors with allocations and means they will be less likely to panic when markets dip. Ultimately this leads to a more successful investing experience and avoids the perils of getting such an important decision wrong. ■

## Investment Counsel News

### *Inside the Office*


*Due to continued positive feedback we've once again renewed Kiplinger's subscriptions for our valued clients.*

### *Outside the Office*

*Chris' son, Blair, recently completed a two week, 800+ mile bike ride from Ann Arbor, Michigan to Washington D.C. While we can all appreciate the grueling physical accomplishment, we're still not sure why he did it.*

*The maximum gain or loss on an investment is impossible to predict. The ranges provided are strictly hypothetical and are designed solely to gauge an investor's risk tolerance. They are not representative of any actual returns, past or future and are not an indication of Investment Counsel's ability to generate returns or protect from losses.