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Asset Allocation

IN MY LAST COLUMN I described how to estimate how much of a mutual fund portfolio is invested in equities, fixed income and cash. This is called the asset allocation of the portfolio and it shows the percentage that each asset class makes up of the total portfolio. This analysis is also applicable to portfolios that contain individual stocks and bonds as well as mutual funds. Bonds, coupons, preferred shares, guaranteed investment certificates and savings bonds belong in the fixed income category. Common shares and income trust units belong in the equity category.

Understanding the asset allocation of a portfolio is important for a couple of reasons. First, it is an indicator of the level of risk in a portfolio. Secondly, it can be used to help forecast the expected long-term return for the portfolio.

The expected return and risk for each asset class is different. Equities can be expected to have a higher return than fixed income or cash, and fixed income can be expected to have a higher return than cash. The risk associated with each asset class generally matches the expected return, so equities are more risky than fixed income or cash, and fixed income is more risky than cash.

Table 1 provides a starting point for assessing the risk level in a portfolio based on the asset allocation between equity and fixed income. For the purposes of this table, cash is included in the fixed income category and is assumed to be a small component of a portfolio.

In *Table 1*, I have defined risk to be the potential decline in portfolio value over a relatively short period of time, that is less than one year and possibly only a few days or weeks. The potential loss figures could be viewed as a typical worst case scenario that is valid about 90% of the time, that is on average 9 out of every 10 years. So once every 10 years, the potential short-term loss may be greater than that shown. Most individual investors have a natural negative emotional reaction if their portfolio value declines over the short-term. Being able to sleep soundly at night is important, and therefore the potential level of short-term loss is an important factor in determining a comfortable asset allocation. As *Table 1* shows, a greater tolerance for short-term loss is expected to lead to a higher long-term expected return as short-term losses are more than offset by gains.

A mismatch between the level of risk an investor believes they are taking on, or what they want to take on, and what is shown in the table warrants further investigation into the portfolio components and structure. For example, an investor that wants a low risk portfolio but has a 75% equity weighting needs to reassess their risk tolerance or portfolio structure.

The long term expected return for a portfolio can also be developed from the asset allocation. A good starting point for expected nominal returns is 9% for equities, 6% for fixed income and 3% for cash. Multiplying the percentage of a portfolio in each asset class by the expected return of that asset class, and then adding up these numbers will equal the expected portfolio return. *Table 1* shows the expected return for various asset allocations. The expected return for each asset class can be adjusted based on differences in portfolio composition, inflation expectations and general return expectations for that asset class.

Table 1: **Asset Allocation and Risk Levels**				
Asset Allocation		**Portfolio Risk**	**Short Term Potential Loss**	**Expected Return**
Equity	**Fixed Income**			
100%	0%	Very High	20%	9.0%
75%	25%	High	15%	8.3%
50%	50%	Average	10%	7.5%
25%	75%	Low	5%	6.8%
0%	100%	Very Low	0%	6.0%

As the asset classes perform differently over time, the asset allocation will naturally move away from the target allocation. Periodic rebalancing back to the target weighting is necessary to ensure that the risk profile and expected return of the portfolio does not deviate significantly from the target levels.

It is important to recognize that the risk levels and expected returns that I have used as examples assume a portfolio that is well diversified within each asset class and contains quality securities. The risk level and expected returns should be adjusted accordingly for portfolios that are heavily weighted to a certain type of security. For example, a portfolio that has a heavy weighting in small capitalization companies, emerging markets or a specific industry sector may be expected to have a higher level of risk and a higher expected return than indicated in *Table 1* for equities. Similarly, a fixed income portfolio that is invested only in short term Government of Canada bonds would have a lower risk level and lower expected return than indicated in *Table 1* for fixed income.

The asset allocation decision is based on taking a long-term perspective of a least several years. This is not to say that it cannot change but it should do so infrequently and based on a fundamental change in an investor's situation. Similarly, the expected returns are a long-term average that can be significantly higher or lower from year to year. In setting the target asset allocation, each investor needs to determine what the balance between expected return and risk is most appropriate for them. This can be a difficult decision but one that needs to be made as it forms the basis of how a portfolio is constructed.