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What Is Asset Allocation?

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Asset allocation. It’s so ingrained in how we manage our clients’ investment portfolios, we talk about it all the time. But what is it? What are assets, and what happens when you allocate them?

Asset Allocation: A Classy Subject

Big picture, an asset is anything beneficial you have or have coming to you. For our purposes, it’s anything of value in your investment portfolio. After bundling your investable assets into asset classes, we allocate, or assign, each asset class a particular role in your portfolio.

To offer an analogy, allocating your portfolio into different asset classes is similar to storing your clothes according to their roles (pants, shirts, shoes, etc.), instead of just leaving them in a big pile in your closet. You may also further sort your wardrobe by style, so you can create ideal ensembles for your various purposes. Likewise, asset allocation helps us tailor your portfolio to best suit you – efficiently tilting your investments toward or away from various levels of market risks and expected returns. Your precise allocations are guided by your particular financial goals.

That’s it, really. If you stop reading here, you’ve already got the basics of asset allocation. Of course, given how much academic brainpower you’ll find behind these basics, there is a lot more we could cover. For now, let’s take a closer look at those asset classes.

Asset Classes, Defined

At the broadest level, asset classes typically include domestic, developed international, and emerging market versions of the following:

- **Equity/stocks** (an ownership stake in a business)
- **Bonds/fixed income** (a loan to a business or government)
- **Hard Assets** (a stake in a tangible object such as commodities or real estate)
- **Cash or cash equivalents**

Just as you can further sort your wardrobe by style, each broad asset class (except for cash) can be further subdivided based on a set of factors, or expected sources of return. For example:

- **Stocks** can be classified by company size (small-, mid-, or large-cap), business metrics (value or growth), and a handful of other factors more recently identified.
- **Bonds** can be classified by type (government, municipal or corporate), credit quality (high or low ratings), and term (short-, intermediate-, or long-term due dates).

We can then mix and match these various factors into a rich, but manageable collection of asset classes – such as international small-cap stocks, intermediate government bonds, and so on.

Generally speaking, the riskier the asset class, the higher return you can expect to earn by investing in it over the long haul.

Asset Allocation, Implemented

To convert plans into action, we turn to select fund managers with low-costs fund families that track our targeted asset classes as accurately as possible. Sometimes a fund tracks a popular index that tracks the asset class; other times, asset classes are tracked more directly. Either way, the approach lets us turn a collection of risk/reward "building blocks" into a tightly constructed portfolio, with asset allocations optimized to reflect your investment plans.

The Origin of Asset Allocation

Who decides which asset classes to use, based on which market factors? To be honest, there is no universal consensus on THE correct answer to this complex and ever-evolving equation. As evidence-based practitioners, we turn to ongoing academic inquiry, professional collaboration, and our own analyses. Our goal is to identify allocations that seem to best explain how to achieve different outcomes with different portfolios. As such, we look for robust results that have:

- **Been replicated** across global markets
- **Been repeated** across multiple, peer-reviewed academic studies
- **Lasted** through various market conditions
- **Actually worked**, not just in theory, but as investable solutions, where real-life trading costs and other frictions apply

Asset Allocation in Action

As we learn more, sometimes we can improve on past assumptions, even as the underlying tenets of asset allocation remain our dependable guide. Bottom line, by employing sensible, evidence-based asset allocation to reflect your unique financial goals (including your timelines and risk tolerances), you should be much better positioned to achieve those goals over time.

Asset allocation also offers a disciplined approach for staying on course toward your own goals through ever-volatile markets. This is more important than most people realize. As Dimensional Fund Advisor's David Booth has observed, "Where people get killed is getting in and out of investments. They get halfway into something, lose confidence, and then try something else. It's important to have a philosophy."

So, now that you're more familiar with asset allocation, we hope you'll agree: Properly tailored, it's a fitting strategy for any investor seeking to earn long-term market returns. Please let us know if we can tell you more.

Source: Dimensional Fund Advisors LP.

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Diversification does not eliminate the risk of market loss.

There is no guarantee investment strategies will be successful. Investing involves risks, including possible loss of principal. Investors should talk to their financial advisor prior to making any investment decision. There is always the risk that an investor may lose money. A long-term investment approach cannot guarantee a profit.

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