INTEGRIS
WEALTH MANAGEMENT

HOW TO SELECT ASSET CLASSES FOR INVESTMENT

Personal Investing Series

Article 9

In the Focus on Asset Class article I proposed to simplify your investing by recognizing that 90% of your portfolio's return is a function of what asset classes are represented there. Instead of picking specific funds or individual securities, and seeing what asset class exposure that results in, you should select asset classes first, and then pick specific investments that fit.

So how do you do that? One thing that can be known about asset classes is their general characteristics and their past behavior. Let's review the three major asset classes - stocks first. Stocks represent ownership, and owners share in any growth of the company. Historically stocks have returned 10% annually and have been an excellent investment for people who have a long term investment horizon, say 10, 15, or 20 years. (Even retirees, it should be noted, have a long term investment horizon for a portion of their funds since they could easily live for another 20 years.) You are also probably aware that stocks can be very volatile in the short term, and are therefore inappropriate for investors who are saving for a specific short term goal, such as a down payment for a house.

I mentioned the previous article of this series that there are different sub classes of stocks. Some examples are large US stocks, small US stocks, European stocks, Asian stocks, emerging market stocks, value stocks, and growth stocks. Each of these different types of stocks have similar general characteristics, that is, they have low double digit expected returns and are volatile. However, a very valuable thing to know about these different sub classes of stocks is that their prices do not move in lockstep. And because this is known, you have an outstanding opportunity to reduce your risk by diversifying. (See Importance of Diversification article)

Since you don't know which stock market will be up in any given year (remember we can't predict the future, see Predictability of the Future articles), then you should invest in a variety of stock markets. If you do this, you know that some of your portfolio will be up and some will be down, but overall you will have fewer really bad years, fewer really great years, and more years that are closer to average. To summarize, what can you know about stocks? They have high returns over the long term, they are volatile over the short term, and they can be diversified to reduce risk.

Let's look at bonds. Bonds are simply loans to corporations and governments, and your return is the interest paid on the loan. Bonds do not have a growth component because at the end, when the loan is repaid, the bond is only worth the amount that was invested. In the meantime, the value of the bond can go up or down as interest rates change, but at the end the bond is only worth its original investment. Another thing you can know is that generally longer term bonds have higher yields and are also riskier in the short term because their prices are more sensitive to changes in interest rates. You can know that historically bonds return less than stocks and have less price volatility. Consequently, bonds are attractive to investors who have shorter investment horizons, are interested in less volatility, and who need a higher cash flow.

Cash. It pays a low yield, which after taxes is sometimes less than the inflation rate. It is almost impossible to lose your original investment if investing in cash type instruments. The thing to know here is that cash is an excellent parking place for short term needs but is a poor investment for the long term.

None of the above involves a prediction about the future except that the relationships between stocks, bonds, and cash will generally persist over the long term. (I did not discuss it here, but there are sound theoretical reasons why the general historical relationships between these asset classes should persist as well.) Yet it has enough information for you to begin to formulate what your investment portfolio should look like. And if I got you thinking about your portfolio in terms of what asset classes it is comprised of, as opposed to specific securities or funds, then we have made progress.

Gifford Lehman
updated 10-2001