**Guide to Asset Allocation, Diversification, and Rebalancing**

Even if you are new to investing, you may already know some of the most fundamental principles of sound investing. How did you learn them? Through ordinary, real-life experiences that have nothing to do with the stock market.

For example, have you ever noticed that street vendors often sell seemingly unrelated products - such as umbrellas and sunglasses? Initially, that may seem odd. After all, when would a person buy both items at the same time? *Probably never - and that's the point.* Street vendors know that when it's raining, it's easier to sell umbrellas but harder to sell sunglasses. And when it's sunny, the reverse is true. By selling both items- in other words, by *diversifying* the product line - the vendor can reduce the risk of losing money on any given day.

If that makes sense, you've got a great start on understanding asset allocation and diversification. This article will cover those topics more fully and will also discuss the importance of rebalancing from time to time.

Let's begin by looking at asset allocation.

**Asset Allocation 101**

Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks, bonds, and cash. The process of determining which mix of assets to hold in your portfolio is a very personal one. The asset allocation that works best for you at any given point in your life will depend largely on your time horizon and your ability to tolerate risk.

* **Time Horizon** - Your time horizon is the expected number of months, years, or decades you will be investing to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable taking on a riskier, or more volatile, investment because he or she can wait out slow economic cycles and the inevitable ups and downs of our markets. By contrast, an investor saving up for a teenager's college education would likely take on less risk because he or she has a shorter time horizon.
* **Risk Tolerance** - Risk tolerance is your ability and willingness to lose some or all of your original investment in exchange for greater potential returns. An aggressive investor, or one with a high-risk tolerance, is more likely to risk losing money in order to get better results. A conservative investor, or one with a low-risk tolerance, tends to favor investments that will preserve his or her original investment. In the words of the famous saying, conservative investors keep a "bird in the hand," while aggressive investors seek "two in the bush."

**Risk versus Reward**

When it comes to investing, risk and reward are inextricably entwined. You've probably heard the phrase "no pain, no gain" - those words come close to summing up the relationship between risk and reward. Don't let anyone tell you otherwise: All investments involve some degree of risk. If you intend to purchases securities - such as stocks, bonds, or mutual funds - it's important that you understand before you invest that you could lose some or all of your money.

The reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you are likely to make more money by carefully investing in asset categories with greater risk, like stocks or bonds, rather than restricting your investments to assets with less risk, like cash equivalents. On the other hand, investing solely in cash investments may be appropriate for short-term financial goals.

**Investment Choices**

A vast array of investment products exists - including stocks and stock mutual funds, corporate and municipal bonds, bond mutual funds, lifecycle funds, [exchange-traded funds](http://www.sec.gov/answers/etf.htm), money market funds, and U.S. Treasury securities. For many financial goals, investing in a mix of stocks, bonds, and cash can be a good strategy. Let's take a closer look at the characteristics of the three major asset categories.

* **Stocks** - Stocks have historically had the greatest risk and highest returns among the three major asset categories. As an asset category, stocks are a portfolio's "heavy hitter," offering the greatest potential for growth. Stocks hit home runs, but also strike out. The volatility of stocks makes them a very risky investment in the short term. Large company stocks as a group, for example, have lost money on average about one out of every three years. And sometimes the losses have been quite dramatic. But investors that have been willing to ride out the volatile returns of stocks over long periods of time generally have been rewarded with strong positive returns.
* **Bonds** - Bonds are generally less volatile than stocks but offer more modest returns. As a result, an investor approaching a financial goal might increase his or her bond holdings relative to his or her stock holdings because the reduced risk of holding more bonds would be attractive to the investor despite their lower potential for growth. You should keep in mind that certain categories of bonds offer high returns similar to stocks. But these bonds, known as high-yield or junk bonds, also carry higher risk.
* **Cash** - Cash and cash equivalents - such as savings deposits, certificates of deposit, treasury bills, money market deposit accounts, and money market funds - are the safest investments, but offer the lowest return of the three major asset categories. The chances of losing money on an investment in this asset category are generally extremely low. The federal government guarantees many investments in cash equivalents. Investment losses in non-guaranteed cash equivalents do occur, but infrequently. The principal concern for investors investing in cash equivalents is inflation risk. This is the risk that inflation will outpace and erode investment returns over time.

Stocks, bonds, and cash are the most common asset categories. These are the asset categories you would likely choose from when investing in a retirement savings program or a college savings plan. But other asset categories - including real estate, precious metals and other commodities, and private equity - also exist, and some investors may include these asset categories within a portfolio. Investments in these asset categories typically have category-specific risks. Before you make any investment, you should understand the risks of the investment and make sure the risks are appropriate for you.

**Why Asset Allocation Is So Important**

By including asset categories with investment returns that move up and down under different market conditions within a portfolio, an investor can protect against significant losses. Historically, the returns of the three major asset categories have not moved up and down at the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns. By investing in more than one asset category, you'll reduce the risk that you'll lose money and your portfolio's overall investment returns will have a smoother ride. If one asset category's investment return falls, you'll be in a position to counteract your losses in that asset category with better investment returns in another asset category.

**The Magic of Diversification.**

The practice of spreading money among different investments to reduce risk is known as *diversification*. By picking the right group of investments, you may be able to limit your losses and reduce the fluctuations of investment returns without sacrificing too much potential gain.

In addition, asset allocation is important because it has major impact on whether you will meet your financial goal. If you don't include enough risk in your portfolio, your investments may not earn a large enough return to meet your goal. For example, if you are saving for a long-term goal, such as retirement or college, most financial experts agree that you will likely need to include at least some stock or stock mutual funds in your portfolio. On the other hand, if you include too much risk in your portfolio, the money for your goal may not be there when you need it. A portfolio heavily weighted in stock or stock mutual funds, for instance, would be inappropriate for a short-term goal, such as saving for a family's summer vacation.

**Resource:**

<http://www.sec.gov/investor/pubs/assetallocation.htm>