THE CHALLENGE

Emma started investing at age 32 with an 85% stocks / 15% bonds portfolio. After three years of strong stock performance, her allocation drifted to 91% stocks. Rather than celebrating, Emma recognized this increased her risk. She rebalanced to 85/15 by selling stocks and buying bonds. Six months later, markets dropped 20% —but her rebalanced portfolio fell only 16.5% instead of 18%. Over her investing lifetime, this discipline added an estimated $180,000 to her retirement wealth.

How can strategic asset allocation, diversification, and rebalancing protect your wealth while still achieving long-term growth?

Learning Objectives

- Design appropriate asset allocations based on age, goals, and risk tolerance.
- Apply rebalancing techniques to maintain target allocations and manage risk.
- Evaluate tax-efficient investment strategies and account type selection.

CORE CONCEPTS

Term	Definition
Asset Allocation	Strategic division of investments among asset classes (stocks, bonds, cash) based on goals, time horizon, and risk tolerance.
Diversification	Spreading investments across securities, sectors, and asset classes to reduce impact of any single investment's poor performance.
Rebalancing	Periodically buying and selling assets to return portfolio to target allocation, typically done annually or when drift exceeds threshold.
Target Date Fund	A fund that automatically adjusts allocation to become more conservative as retirement approaches.
Asset Location	Strategic placement of investments in taxable vs. tax-advantaged accounts to minimize overall tax burden.

Background: Asset allocation—your mix of stocks, bonds, and other investments—is the single most important factor in portfolio performance, explaining over 90% of return variation. A 25-year-old with 40 years to invest needs a different allocation than a 60-year-old retiring soon. Common guidelines like **"110 minus**

your age" suggest stock percentage, but your specific goals, income stability, and **risk tolerance** matter too. Effective diversification, regular rebalancing, and tax-efficient strategies can add hundreds of thousands of dollars to your lifetime wealth.

APPLY IT

PART A: LIFE-STAGE ASSET ALLOCATION

Design appropriate allocations for each investor profile and justify your decisions.

Profile 1: Recent Graduate (Age 25)

Stable job, $48,000 salary, no dependents, 40 years until retirement. High risk capacity due to long time horizon.

Stocks: _____ %

Bonds: _____ %

Because: _____

Profile 2: Mid-Career Professional (Age 45)

$95,000 salary, $180,000 saved, two children, 20 years until retirement. Moderate risk capacity.

Stocks: _____ %

Bonds: _____ %

Because: _____

Profile 3: Pre-Retiree (Age 60)

$550,000 saved, retiring in 5 years, needs income for 25+ year retirement. Low risk capacity near-term.

Stocks: _____ %

Bonds: _____ %

Because: _____

> **Hint:** *Use "110 minus age" as a starting point for stock allocation. But remember: longer time horizons support more stocks; near-term needs require more stability.*

PART B: REBALANCING IMPACT ANALYSIS

Track how rebalancing affects portfolio risk and returns over time.

Year	Stock Return	Bond Return	Non-Rebalanced Allocation	Rebalanced Allocation

Start	—	—	80% / 20%	80% / 20%
Year 1	+25%	+4%	83% / 17%	80% / 20%
Year 2	+12%	+3%	85% / 15%	80% / 20%
Year 3	-18%	+5%	Calculate impact below	

4. In Year 3 (stock crash), which portfolio loses more money—the one that drifted to 85% stocks or the one rebalanced to 80%? Calculate each.

Show your work (assume $100,000 portfolio):

Non-rebalanced loss: $_____ | Rebalanced loss: $_____

5. Why does rebalancing force you to "buy low and sell high" even though it feels counterintuitive?

_____

_____

PART C: TAX-EFFICIENT ASSET LOCATION

6. David has $100,000 in a taxable account and $100,000 in a traditional IRA. He wants 60% stocks / 40% bonds overall. Which placement is better for taxes, and why?

Option A: 60/40 split in both accounts | **Option B:** 100% stocks in taxable, 20/80 stocks/bonds in IRA

Better option: _____ (A / B)

Because: _____

_____

7. Based on what you've learned, describe your ideal portfolio allocation, rebalancing plan, and one tax strategy you would use.

_____

_____

_____

CHECK YOUR UNDERSTANDING

1. The factor that explains over 90% of portfolio performance variation over time is:

- ☐ A. Individual stock selection
- ☐ B. Market timing
- ☐ C. Asset allocation
- ☐ D. Fund manager skill

2. Explain why a 25-year-old can afford more stock exposure than a 60-year-old, even though stocks are riskier.

_____

_____

3. Calculation: An investor contributes $500/month for 30 years. With good portfolio strategy adding 0.5% extra annual return (8.5% vs. 8%), how much additional wealth is gained?

Show your work:

Additional wealth from 0.5% improvement: $_____

4. Sofia started with 90% stocks at age 25, then shifted to 85/15 at 35, 75/25 at 45, and 60/40 at 55. Why is this gradual shift better than staying at 90% stocks or switching suddenly at retirement?

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5. Reflection: Based on your current age, goals, and honest assessment of risk tolerance, what asset allocation would be appropriate for you? What would cause you to adjust this over time?

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