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Asset Allocation Secrets For Maximum Returns And Minimum Risk

Dan Eggertsen: I'd like to welcome everyone to the call. This is Dan Eggertsen. I'm here with my dad, Karl Eggertsen. How you doing Dad?

Karl Eggertsen: Doing real good Dan.

Dan Eggertsen: Well good. So today we are going to be fielding three questions about asset allocation. These are questions that have been asked by many people on our list. I have taken all the questions and summarized the ones I see over and over again into the top three. So are you ready to hit these?

Karl Eggertsen: Yeah ready to go Dan.

Dan Eggertsen: All righty. The first question is, "What is asset allocation and how do you recommend someone sets it up properly?"

Karl Eggertsen: Okay asset allocation is probably the most important thing that a person can do in setting up a portfolio. It represents – major studies have shown that it represents around 96% ultimately of the returns that you're going to get with the specific stocks, the specific mutual funds, the specific bonds, real estate, REITS whatever.

The selection of specific mutual funds or specific securities is only about 4% of your return and this is over long periods of time done by groups of very smart of people and a number of major studies. So asset allocation is absolutely critical. It's a technique – what it is, it's a portfolio technique that strives to balance return and risk and it creates diversification by dividing assets among major investment categories such as stocks, real estate, bonds, and cash.

Each asset category has very different levels of return and risk in different market environments. So each will behave differently over time and this really gives you about the best protection you can really have against major losses should an investment category or two go amiss.

Dan Eggertsen: Right.

Karl Eggertsen: Okay? So asset allocation has been shown as I said, in major studies to be the most important decisions investors can make and it's responsible for a vast majority of a portfolio's return. So it's more important in how you allocate and weight high and low risk stocks, short and long term bonds, and cash than it is to select specific securities, specific mutual funds. Trying to pick the winners is only going to get you about 4% of the total return you're ultimately going to get with asset allocation being the other 96%.

Dan Eggertsen: Wow.

Karl Eggertsen: So it's a real critical thing for investors to understand. Most investors don't understand that. They think they got to pick the next Microsoft or whatever. No. They're probably not going to do it. They're very unlikely to do and the chances of that are extremely minute. What really matters is asset allocation of the broad categories of assets like bonds, cash, and stocks.

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Okay so. So there's not simple formula that can find the right asset allocation for every individual. It is something very unique to every person, every family. Here are a few points that can help people do that.

Dan Eggertsen: Okay.

Karl Eggertsen: The younger investors and investors with a high risk tolerance, in other words those investors that don't get squeamish when a bear market hits and they see the value of their portfolio plummeting for a while. The investors who can hold tight, who can keep their head and not get emotional and make bad decisions, those are the ones that should allocate more of their money to the higher risk investments such as stocks and real estate.

Dan Eggertsen: Right.

Karl Eggertsen: They offer a higher return but there's more risk of loss. Okay? Older investors on the other hand or investors with less risk tolerance should have a lower allocation of the higher risk categories like stocks and real estate. They should have more bonds and cash and not as many stocks for example.

Dan Eggertsen: Gotcha.

Karl Eggertsen: Okay? So that's the second point. The third point would be each asset class has varying levels of return for certain risk. So the things that would help, you know, that are important for an investor to consider is their risk tolerance. Okay that's one thing. Another thing is their time horizon. How many years until they're going to retire? How many more years until their kids are going to be in college and what is their age at the time they're trying to make a decision on asset allocation. So time horizon is the second point.

Third point would be investment objective. What are your goals and how much money is it going to take for those goals. The third thing of course is available capital. How much money

you have to asset allocate and if somebody has a lot of money to allocate, then they're going to probably be making some different decisions on asset allocation than somebody who has less cash.

The person who has less is probably going to be more interested in getting some growth, more growth than somebody who has a bundle of cash. They'd be more interested in safer investments to keep what they have but still have some for growth. So those are some of the key points. Now for a young professional, okay?

Dan Eggertsen: Actually this is leading into my second question so I might as well ask the question before you start in there.

Karl Eggertsen: Okay.

[06:36.4]

Dan Eggertsen: I'm a young professional with a family. Can you outline a basic asset allocation setup for me? So what do we tell someone that's young, has a family, and is making a little bit extra money every month? How do they diversify that and do a good asset allocation scenario?

Karl Eggertsen: Okay. Well not having any more information than a young professional with a family. So what I'm assuming here, and this is an example of a real world type situation, a young professional with a wife and some kids and say he has two kids. They're young kids in elementary or middle school. They have a long time horizon. Okay? Their risk tolerance is because of a pretty long time horizon is higher than a couple who is much closer to retirement.

They need to have some liquidity for family, unexpected family situations that might come up. Family emergencies, you know, a family of kids you never know what you're going to need some cash for. So they're going to need to have some liquidity and some stableness in their portfolio. They don't need to go for broke; they shouldn't go for broke on a high risk portfolio.

So I would say a fairly aggressive portfolio of maybe 65% to 70% equities. Okay? And with about 20% to 25% of fixed income, that would include bonds and 5% to 10% cash in money market and T Bills where they're very liquid and for unexpected things where you're going to need some cash. So with the 70% and up to 70% equity in stocks and real estate, they're going to have good growth and good growth prospects along with the stableness that's provided by around 30% or so of fixed income and cash.

So it would weather the ups and downs pretty well and they would always have the liquidity of the cash and also the stableness provided by bonds and good growth prospects. So for a family like this, I think that that would be a pretty prudent way to go. Not knowing any more about the size of the family and the personalities of the couple and details on their goals and needs but that would seem to be a pretty good mix.

Dan Eggertsen: Yeah it's important for everyone to realize not just go run out and do exactly what my dad said without consulting for your specific situation because it's important to take other things into account rather than just you're a young professional with a family. There's just not enough information to really coming out with a detailed asset allocation plan for you. But those are the basics and you laid them out pretty good Dad.

Karl Eggertsen: Thank you.

Dan Eggertsen: Yeah. Okay let's move on to question number three. "I'm looking to retire in the next five or six years and I want to make sure I have my asset allocation set up right. Can you go over the basics of asset allocation for a guy in my situation?"

Karl Eggertsen: Okay so here we have – I'm assuming this is an individual. We don't know any more than a person saying I'm looking to retire. So I'm going to assume this is an individual, a single person, man or woman and they're interested in retiring in five or six years.

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Don't know their age, don't know any other details other than they're going to retire in five or six years and they want some tips on that. So what we have to go by is time. Okay? That's getting pretty close to retirement. So I think a moderately conservative portfolio seems appropriate for an individual seeking to retire in five to six years.

Moderate, I'm talking about a portfolio of 50% to 55% in equities and that still provides some growth for the next few years. It's close enough to where they should be on the other hand also when they do retire, on the day they retire. This is not far away.

Dan Eggertsen: Right.

Karl Eggertsen: So 50% to 55% I would recommend they be positioned in equities, a variety of equities; US and foreign. The whole gamut of stock equities and maybe some real estate in the form of real estate investment trust. The rest should be in fixed income and cash.

Dan Eggertsen: Okay.

Karl Eggertsen: As they get within one to two, three years – after two or three years when they get that close to retirement, I would recommend that they gradually reduce their equity to around 50% in stocks and be moving more and more of their equity into the fixed income. So at retirement they're about 50/50. Now I'm assuming this person's probably going to be about 60 to 65, somewhere in there.

A person that age should be looking, in today's world with the length of people, they're living into their 80s and beyond so retirement could be 25, 30 years and that 50/50 at retirement would be a good place to be. Half in equity in a basket of equities and half fixed income and cash and you can put that in your other basket. At retirement they would be familiar and asset allocated

appropriately for retirement. They would have had several years to really get positioned on how to manage that money.

When they need to start taking equity, when their salary stops, they retire they can start taking income from the fixed income side. So whatever income is being churned off by the fixed income and cash, they could take the amount of money that they should at that point, you know that they require along with any other income that they have and keep doing that for a number of years.

If that becomes drawn down to a certain extent, maybe it gets down to 40 to 45%, after a number of years, you could move some of your growth equities in the other basket that have been untouched and growing all along you can move some of that over and get back to your asset allocation of 50/50.

Dan Eggertsen: Right.

[13:58.0]

Karl Eggertsen: That would be, I think a very appropriate for an individual like this to manage their assets at retirement. So the above two scenarios are meant to show how two example situations of young family starting up and individual person planning on retiring in a few years.

This gives an idea about the kind of thinking that should go in for each individual as they're planning and asset allocating their portfolio and what their needs are and their personality characteristics and what their goals are and how much time they have. All these things go into making up a portfolio that is appropriate for each case.

Dan Eggertsen: Right.

Karl Eggertsen: So it's got to be tailored. There is no magic. This is the kind of thinking that needs to go into it. It's extremely important to do because again, it's about 96% of the return that you're going to get out of your portfolio is going to be based on your asset allocation.

Dan Eggertsen: Yeah. I actually remember seeing, it was a chart and it had three scenarios of a person investing \$1,000 a month in a diversified portfolio and chart one was showing them investing \$1,000 a month at the perfect time. So they bought exactly when the market was at its lowest. Every time they put \$1,000 in every month, the market was at its low peak for the month and they just bought at the perfect right time every time.

The middle chart was, you know, they bought at the right time some months and other months they bought at the worst time so it was kind of split. The third scenario was they bought at the exact wrong time every month. The market was at its highest every month when they bought. At the end of 20 years or something, there really wasn't that much difference between situation one and situation three.

Karl Eggertsen: That's very interesting.

Dan Eggertsen: Yeah so.

Karl Eggertsen: That is very interesting.

Dan Eggertsen: Yeah I mean there was a difference but it wasn't as much as you'd think. So the point is, timing the market is not nearly as important as getting the asset allocation right.

Karl Eggertsen: Yeah. That's something that all the listeners to this should understand. There're some real important tips that we're both providing on the asset allocation and on the timing and how the market is doing. It's consistency, it's patience, it's a timing, trying to time the market is near impossible. Warren Buffet admits he can't do it. If he can't do it who's going to be able to do it?

Dan Eggertsen: Right.

[16:52.9]

Karl Eggertsen: You've got to have patience, you've got to be smart in how you asset allocate, and you've got to be consistent in sticking with your strategy all along and tailoring everything from the beginning to what your needs and your goals are in your life, in your financial life.

Dan Eggertsen: Yes.

Karl Eggertsen: Timing. There's a lot of people sell a lot of newsletters, expensive newsletters telling people, "You take my newsletter I'll tell you exactly when to get in and out of the market." That doesn't work. It does not work. There's a guy named Mark Hulbert who monitors dozens and dozens of major newsletters all across the country and this is what he finds. Timing is not something you can depend on. It gets very expensive jumping in and out of the market because you're buying and you're selling and there're all these trading costs, and you're also paying taxes on any capital gains.

Dan Eggertsen: It really gives you a disadvantage.

Karl Eggertsen: And you can't have a life. I mean you're trying to monitor every day what's going on and you're trying to beat the market. And if the pros can't do it consistently and Warren Buffet can't do it consistently, we need to be smart investors and work with the tried and true principles that really are key to financial success and financial independence and security.

Dan Eggertsen: I couldn't agree more.

Karl Eggertsen: Okay.

Dan Eggertsen: Well thank you so much Dad. Great job and I thank everyone for being on the call and thank you so much for your time Dad. We'll talk soon.

Karl Eggertsen: Okay. Talk to you later. Bye.

Dan Eggertsen: Bye bye.

[18:38.4]