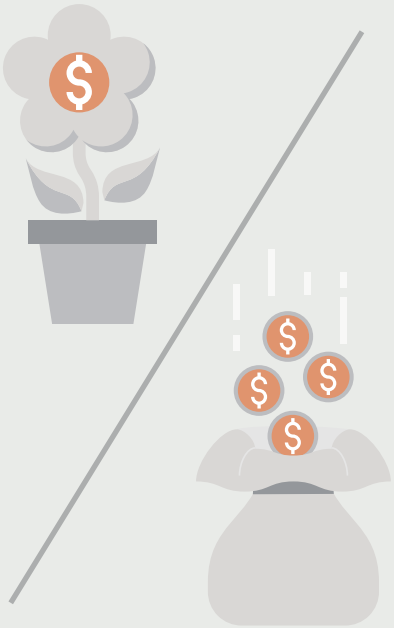
The Basics of Asset Allocation



In simple terms, asset allocation refers to the balance between growth-oriented and income-oriented investments in a portfolio. An optimal approach allows the investor to take advantage of the risk/reward tradeoff and potentially benefit from both equity and fixed income. Here are some basic steps to asset allocation:

1. Choosing which asset classes to include (stocks, bonds, cash, real estate, alternatives, etc.)
2. Selecting the ideal percentage (the target) to allocate to each asset class
3. Identifying an acceptable range within that target
4. Diversifying within each asset class

Minimizing risk while maximizing return is any investor's prime goal, and the right mix of securities is key.

Of course, the appropriate mix for a particular client depends upon many factors, including risk tolerance, time horizon and financial goals. For example, an investment advisor with a client who owns commercial real estate properties or a number of rental homes would probably not recommend real estate investment trusts (REITs) or other real estate securities in the investment portfolio.

Risk Tolerance

The client's risk tolerance is the single most important factor in choosing an asset allocation. Most advisors will use a risk tolerance questionnaire or an extended interview to make sure they have an accurate measure of risk. At times there may be a distinct difference between the risk tolerance of a client and his/her spouse, so care must be taken to reach agreement on how to proceed. In addition, risk tolerance may change over time, so it is important to revisit the topic periodically.

Time Horizon

Clearly, the time horizon for each client's goal will affect the asset allocation mix. Take the example of a client with a very aggressive risk tolerance. The recommended allocation to stocks and bonds may be much higher for the client's retirement portfolio than for the money being set aside for the college fund of the client's then 13-year-old child.

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Strategic vs. Tactical Asset Allocation

Strategic asset allocation calls for setting target allocations and then periodically rebalancing the portfolio in line with those targets as investment returns skew the original asset allocation percentages. The concept is generally not highly active from a trading perspective. Of course, the strategic asset allocation targets may change over time as the investor's goals and needs change and as the time horizon for major events such as retirement and college funding grows shorter.

Tactical asset allocation allows for a range of percentages in each asset class (such as stocks = 40-50%). These are minimum and maximum acceptable percentages that permit the advisor to seek to take advantage of market conditions within these parameters. Thus, a minor form of market timing is possible, since the advisor can move to the higher end of the range when the advisor expects stocks to do better and to the lower end when the economic outlook appears bleak.

Conclusion

The right approach to asset allocation will be tailored to each investor's particular needs, informed by their investment goals, timeline and risk tolerance. Because all of these factors will change over time, asset allocation is not a "set it and forget it" process. Investors should engage with their advisors to explore how they can seek to maintain an optimal balance of risk and reward in an ever-changing market environment.

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Investing involves risk, including possible loss of principal.

Investments in stocks are subject to numerous risks including but not limited to market risk, manager risk, economic conditions, local and international political events, credit and liquidity risk.

Investments in fixed income securities are subject to risks such as default risk and fluctuations in the perception of the debtor's ability to pay its creditors. Changing interest rates may adversely affect the value of an investment. An increase in interest rates typically causes the value of bonds and other fixed income securities to fall.

Real estate investments may be subject to factors such as changing general and local economic, financial, competitive, and environmental conditions.

Alternative investments are speculative, subject to high return volatility and involve aggressive investment techniques and a high degree of risk including, but not limited to, the risks associated with leverage, derivative instruments such as options and futures, commodities, and distressed securities may be illiquid on a long term basis and short sales. There can be no assurance that these types of strategies will achieve their objectives or avoid substantial losses.

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