Citi Personal Wealth Management

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FINANCIAL EDUCATION SERIES 2010

Doing the Splits: How to Divide Your Money Between Stocks and Bonds

Folks often start their investment search by scanning the mind-boggling variety of stocks, bonds, mutual funds and other investments, trying to figure out which are "best."

But this approach can leave folks hopelessly confused – and the resulting mix of investments may make little sense as a portfolio. The problem: These investors have got it backwards. Typically, picking investments should come last, not first. So what ought to come first? Read on.

DIVIDING THE PIE

Consider starting with your so-called asset allocation, which is your portfolio's basic split between stocks, bonds, hard assets and cash investments. Cash investments include things like savings accounts and money market funds, while the hard-assets category encompasses investments such as gold, commodities and real estate.

One much-cited and much-debated study found that more than 90% of a portfolio's performance is determined by its asset allocation. Some folks have quibbled with this 90% number. Still, the importance of asset allocation is hard to deny. Think of it this way: You will find it difficult to squeeze stock-like returns from high-quality bonds. And – fingers crossed – you shouldn't over the long haul get bond-like returns from your stocks. If you have more in stocks, the ride is likely to be rougher, but history suggests your long-run returns ought to be higher.

So what asset allocation should you use? There are two key factors. First, give some thought to your time horizon. If you have five years or less until you will need your money, you should probably favor bonds and cash investments. But as your time horizon lengthens, you can take the risk of investing more of your money in stocks and hard assets.

That said, even if you have decades until you will spend your savings, you shouldn't invest heavily in stocks and hard assets until you consider the second factor, which is your stomach for risk. This is trickier than it seems, because investors' risk tolerance often varies over time. During rising markets, folks tend to be happy owning stocks and other riskier investments. But their appetite for stocks often disappears amid market declines.

THINKING BIG

As you settle on your asset allocation, try to take a broad view of your finances, considering things like the value of your earning power, your real estate, your mortgage, your Social Security benefit and any pension you're entitled to.

For instance, financial advisers often recommend investing more heavily in stocks when you're in your 20s and 30s and then shifting toward bonds as you approach retirement. The reason: As you consider quitting the work force, you may want to replace the regular income from your paycheck with the regular income offered by bonds.

While bonds will pay you interest, servicing your debts means paying interest to others, and you may want to figure that into your financial decisions. If you have $150,000 invested in bonds and other interest-paying investments, but you also have debts equal to $100,000, arguably your net bond exposure is just $50,000 – and thus your financial situation may be more precarious than your $150,000 bond position suggests. Indeed, if you're looking to invest more in bonds, you may be better off paying down your debts instead.

Similarly, you might factor in Social Security and any pension you're entitled to. Social Security retirement benefits rise each year along with inflation, while most pensions remain fixed. Because both provide regular income, you may find you don't need to invest quite so much in bonds. One implication: If much of your spending needs in retirement will be covered by your Social Security and pension income, you might consider allocating more of your portfolio to stocks.

Finally, as you settle on your asset allocation, consider your home and any other real estate you own. To be sure, homes can be difficult to sell and you need to live somewhere. Still, real estate is usually considered a "hard asset" – and hard assets are often viewed as a good hedge against accelerating inflation.

That's prompted some investors to allocate 5% or 10% of their investment portfolio to real estate investment trusts and other real estate securities. But if you already have healthy exposure to real estate, because you own multiple homes or you have invested in rental properties, you might want to put less of your investment portfolio into real estate securities.

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SPREADING IT AROUND

Once you have settled on your basic mix of stocks, bonds, hard assets and cash investments, you will need to decide how you will diversify within each of these categories. You might opt to split your stock market money so that you have, say, 70% in U.S. stocks and 30% in foreign stocks. From there, you might drill down further, dividing your U.S. stock exposure into large stocks and small stocks and splitting up your foreign exposure between developed foreign markets, such as Germany, Japan and the U.K., and emerging markets like Brazil, China and India.

If you want to get even more elaborate, you might earmark a percentage of your stock portfolio for, say, U.S. mid-cap stocks and for small stocks in developed foreign markets. You might also divvy up your exposure between growth stocks, which hold out the possibility of rapid revenue and earnings growth, and value stocks, those shares that appear less expensive compared to current earnings or corporate assets.

As you decide which sectors to own and how much to invest in each, make a point of writing down what your target portfolio should look like. This will provide a useful reference, especially at times of market turmoil.

Diversifying across a host of market sectors is no guarantee against losses. Still, because your money is spread so broadly, you may not be hurt too badly if any one sector gets hit hard. That could mean smoother short-term portfolio performance — and that, in turn, may make you a more tenacious investor, so you stick with your stocks at times of market turbulence.

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For more information, please contact your Citi Personal Wealth Management advisor.

Sourcing: To read more about the importance of asset allocation in driving portfolio returns, see "Determinants of Portfolio Performance" (*Financial Analysts Journal*, July-August 1986) by Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower. This study has triggered an ongoing debate about just how important asset allocation is.

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