Eagle Strategies LLC

Investment

PLANNING ESSENTIALS

Asset Allocation & Diversification: The Pillars of Your Financial Plan

When it comes to investing in the stock market, there are very few absolutes. One certainty, however, is that attempting to accurately predict the day-to-day movements of the market is a strategy doomed to fail. Global markets are too unpredictable. Economic fundamentals are constantly in flux. And investor sentiment can turn on a dime.

Even when there's a broad-based global economic expansion underway, certain countries, sectors, and asset classes will significantly outperform others. One-year large cap stocks might lead the way, the next high yield bonds, and the year after that foreign stocks. However, attempting to predict which asset classes will outperform from year to year is futile.

Of course, there is one sure way to avoid market risk; just don't invest. But that's really a case of trading one potential risk for two others (inflation risk and longevity risk) that are much more likely, and which

KEY TAKEAWAYS:

Employed in tandem, asset allocation, and diversification can help to reduce overall portfolio risk and smooth out some of the bumps during volatile markets.

While asset allocation refers to the percentage of stocks, bonds, and cash in your portfolio, diversification involves spreading your assets across asset classes within those three buckets.

It's important, however, to not just diversify across the various asset classes, but also globally (76% of the world's GDP is generated outside the U.S.).[1]

can leave you even further from your goals than when you started. For long-term investors, the best way to grow your assets while minimizing your risk is by way of two fundamental investment strategies: asset allocation and diversification.

What's the difference between asset allocation and diversification?

Although the two terms are often used in tandem, asset allocation and diversification describe different but related strategies. Asset allocation refers to the percentage of stocks, bonds, and cash in your portfolio. As such, it's the main determinant of your investment risk—from a 100% stock allocation (highest risk) to a 100% cash allocation (lowest risk). In contrast, diversification describes the spreading of your assets across the various asset classes within each of those three allocation buckets to further reduce risk.

For example, given your age, goals, and risk tolerance, perhaps a 60% stock, 30% bond, and 10% cash allocation is appropriate for your needs. But if that 60% stock allocation is invested solely in large cap U.S. tech stocks—without broad exposure to other sectors (e.g., consumer cyclicals, energy, financials, small caps, etc.) or regions (e.g., foreign stocks and bonds, emerging markets, etc.)—then it lacks diversification. Regardless of your chosen asset allocation, the more diversified your portfolio, the more predictable and less volatile your returns.

The risk-reward tradeoff

By reducing overall portfolio risk through effective asset allocation and diversification, you won't keep pace with the returns of the best performing asset class each year, but you also won't match the returns of the worst performing asset class. Instead, these strategies are specifically designed to help smooth out some of the bumps.

Because of this, it's important to avoid the common mistake of gauging your portfolio's investment performance against the returns of the Dow Jones Industrial Average (which represents just 30 of the largest U.S. companies) or even the S&P 500® which is comprised solely of large cap U.S. stocks. In fact, aside from periodic rebalancing, the best thing you can probably do is to turn off the financial news and allow time to do its job. When the stock market is steadily rising, it may feel a bit frustrating, but when things head south, you'll more than appreciate being well-allocated and diversified.

Don't forget to diversify globally

As Americans, we sometimes fall into the trap of being too parochial and provincial when it comes to the world of investing. Despite the fact that 96% of the world's population (generating 76% of the world's GDP)[1] live outside the U.S., our financial vision tends not to extend past our shores. Not only is there tremendous economic growth occurring in markets around the globe, they provide you with a tremendous opportunity to achieve considerably greater diversification. And today, given the wide range of ETFs and no-load mutual funds available, you can invest in hundreds of established and emerging global leaders with just one or two carefully chosen funds.

While asset allocation and diversification cannot guarantee a profit or protect against losses, over time, a properly allocated and well-diversified portfolio is designed to provide you with competitive returns while reducing overall market risk.

Have specific questions or want additional information about how to achieve a better allocated and more diversified portfolio? Talk to your Eagle Strategies Financial Advisor.

[1]Source: The World Bank Group, 2021.

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