What is asset allocation and how does it work?

Answer:

Asset allocation is a technique used to spread your investment dollars across several asset categories. Stocks, bonds, and cash or cash alternatives are the most common components of an asset allocation strategy. However, others may be available and appropriate as well. The general goal is to minimize volatility while maximizing return (though asset allocation alone can't ensure a profit or eliminate the risk of a loss). The process involves dividing your investment dollars among asset categories that do not all respond to the same market forces in the same way at the same time. Though there are no guarantees, ideally, if your investments in one category are performing poorly, you will have assets in another category that are performing well. The gains in the latter will offset the losses in the former, minimizing the overall effect on your portfolio. Remember that all investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful.

The number of asset categories you select for your portfolio and the percentage of portfolio dollars you allocate to each category will depend, in large part, on the size of your portfolio, your tolerance for risk, your investment goals, and your time horizon (i.e., how long you plan to keep your money invested). A simple portfolio may include as few as three investment categories, with a percentage of total dollars divided among, for example, cash alternatives, bonds, and stocks. A more complex portfolio may include many more asset categories or break down each of the broader asset categories into subcategories (for example, the category "stocks" might be further divided into subcategories such as large cap stocks, small cap stocks, international stocks, high-tech stocks, and so on).

Determining an appropriate asset allocation may be the most important single investment decision you make, because it will likely have more impact on your overall return than the selection of individual investments. Don't hesitate to get expert help if you need it. And be sure to periodically review your portfolio to ensure that your chosen mix of investments continues to serve your investment needs as your circumstances change over time.