KALABASH FINANCIAL

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THE VALUE OF ASSET ALLOCATION

After rising for much of this year, there was a significant decline in the stock market this summer caused by a growing credit problem in the housing market. Several banks and brokerages that lent money to "risky" borrowers now face the possibility of defaults.

Is this the end of the world? No, my guess is that this is part of the normal business cycle. To weather these types of storms, I encourage my clients to follow an Asset Allocation Strategy.

ASSET ALLOCATION DEFINED

Asset allocation is an investment strategy of dividing your money among different asset categories (typically stocks, bonds and cash). Based on the principal of diversification, each investor finds the right mix based on their time horizon and risk tolerance to reach their goal.

Asset Allocation, which is driven by complex mathematical models, should not be confused with the much simpler concept of diversification. Keep in mind that while diversification may help reduce volatility and risk, it does not guarantee future performance.

THE ASSET CLASSES

In basic portfolio management, there are three basic classes of investment that represent different levels of risk and return.

Stocks represent fractional ownership in a business. The value normally increases when business is good but declines when business is bad. With almost unlimited possibilities, stocks offer the highest potential for gains, but this could be coupled by wide swings in its value.

Bonds are the debt of businesses and governments. They offer a promise to pay interest and return of principal for a specific period of time. This makes them more predictable than stocks, but there will be some fluctuations in value.

Cash includes all short-term investments (savings, certificates, money market accounts and the like). These have little to no fluctuation in their account value, but offer the lowest returns because of their safety.

Because each investment class has different characteristics, mixing them seeks to maximize returns while reducing the degree of ups and downs. In practical terms, you give up some of the upside potential in exchange for more stability and vice versa.

TIME HORIZON & RISK TOLERANCE

Deciding exactly how much is allocated in each asset class is a mater of personal choice. However, the decision should be based on two key factors.

When do you plan to use the money and how much you will need determines your investment time horizon. Generally, the more time you have the more risk you can afford to take. Saving to buy a house in 5-years requires a more conservative approach than saving for retirement in 25-years.

Risk tolerance is unique to each person. Even if the time horizon allows for more risk, it is not worth worrying over. Those concerned over sudden declines in their investments need the security of holding more bonds and cash. It is important to be honest in this regard.

MANAGING YOUR PORTFOLIO

When using an Asset Allocation strategy, it is important to periodically reallocate your investments to maintain balance. There will be times when the value of an asset class declines or rises to exceed the target allocation.

This periodic maintenance helps maintain diversification while encouraging a buy low and sell high discipline. Consider reviewing your allocations at least once or twice a year.

The table below gives an example of how various allocations have performed from 1926–2005. This is for illustration purposes only. Your actual results will vary.

If you would like to learn more about this strategy or a complementary portfolio review, please call me at 539-0133.

SAMPLE PORTFOLIOS 1926–2005

% Asset Allocation	Portfolio I	Portfolio II	Portfolio III	Portfolio IV
U.S. Stocks	20%	45%	60%	70%
Foreign Stocks	0%	5%	10%	15%
Bonds	50%	40%	25%	15%
Cash	30%	10%	10%	0%
Results				
Best Year	31.06%	76.57%	109.55%	136.07%
Worst Year	-17.67%	-40.64%	-52.92%	-60.78%
Average	6.14%	8.16%	9.20%	9.91%

Source: Ibbotson Associates, 2006 (1926-2005). Information is for illustrative purposes only. Past performance is no guarantee of future results. Indexes used: Stocks = S&P 500; Bonds = U.S. Intermediate Government Bond; Cash = U.S. Treasury; Foreign Stocks = MSCIEAFE 1970–2005 and S&P 500 1929–1970. It's not possible to invest in an index.