Philequity Corner

March 12, 2007
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Investment Basics: Asset Allocation

Remember the old adage about not putting all your eggs in one basket? It applies just as appropriately to investments. In financial parlance, it is called Asset Allocation. Simply put, asset allocation is a way of spreading your investments across various asset classes such as cash, bonds and stocks.

Asset allocation is a crucial part of the investment decision-making process and it serves two general purposes. First, it provides variety to one's portfolio and thereby helps spread the risks. This is also called diversification. Second, it also allows one to take advantage of opportunities and favorable conditions involving a particular asset class.

Define your investment profile

Before embarking on asset allocation, one should set or characterize his investment profile. To do this, one should determine certain factors such as the following:

1. **Investment horizon**. This refers to the period in which you intend to achieve a financial goal such as saving for college expenses, buying a house, or retirement. In most cases, we may need to set several goals simultaneously. Therefore, be realistic. More goals mean saving (and investing) more and possibly over a longer time frame. In this case, it would be advisable to start early.

2. **Risk profile**. This refers to one's willingness to take a certain degree of risk. As a basic maxim, targeting high returns entails taking equally high risks. Also, the younger you are and the earlier you start investing, the higher risk that you can tolerate because you have more time and opportunity to recover should your portfolio yield poor returns initially. Furthermore, you can also afford to be more aggressive and allocate more of your funds into riskier but potentially more rewarding investments. The opposite is also true: the older one gets, the lower would be his risk tolerance as there might be little time and opportunity left to recover from initial poor investment yields. In this regard, it is more prudent for them to keep their funds into "safer" investment instruments.

Research on fundamentals

Aside from defining your investment profile, you will also need to consider current economic circumstances and which asset class they favor. It is on this note that we once again emphasize the value of research and the need to focus on economic and research fundamentals.

For instance, in a high interest rate scenario, it would be prudent to allocate more of your resources in cash and near-cash investment vehicles such as deposit instruments and Treasury bills/notes and less on bonds and stocks. The reverse is also true: a low interest rate regime would favor stocks and bonds.

In the event that you need to allocate part of your funds in stocks, do intensive research on the companies that you will be investing in. Consider the earnings and growth prospects, credibility and integrity of management, extent or possibility of dividend yields (see our article *Stock Market 101*, *Philippine Star* November 20, 2006 issue). A conservative stance would be to keep your stock investments on high-quality companies (blue chips). In a more aggressive positioning, one can consider smaller but promising companies which are likely to post strong earnings growth and can potentially become blue chip companies.

Stocks and mutual funds

In doing your research, you can also consult your broker's research group. In case you don't have a broker or the time and resources to do intensive research, you can shorten the process by investing in mutual funds. Mutual funds, such as Philequity, are usually backed by strong research groups which help fund managers make informed investment decisions.

At any rate, you still need check on the track record of the mutual fund and the qualifications of its fund managers (see our article Basics of Mutual Fund Investing, Philippine Star, November 27, 2006 issue). Have a clear idea as to how such mutual funds performed under both good and bad market conditions. For new investors, mutual funds can substitute for stocks until they become more familiar with stock investing. For professionals and businessmen who are too busy to research on stocks, equity mutual funds can be a good alternative.

Setting allocations and portfolio rebalancing

After having a clear grasp of your investment profile and market fundamentals, you can now set an initial allocation. For illustrative purposes, below is a sample of an asset allocation.

Asset Class	Weight
Cash	10%
Government bonds	20%
Dollar bonds/RoPs	20%
Mutual funds	20%
Stocks	30%

Prudence dictates that we should keep a close watch on the performance of our portfolio and continue monitoring market fundamentals. If there are changes in the latter, we should be ready to do some reallocation or rebalancing on our portfolio and put more weight in asset classes which are benefiting from prevailing market conditions. This needs to be done from time to time in order to take advantage of market opportunities and ensure optimum portfolio performance.

Recent market fall: a good time for asset allocation

The recent market fall has made stock valuations become more reasonable. It also provides a good opportunity for asset allocation or rebalancing. Banks, for instance, which have long been keeping much of their investments in cash instruments, should now find a good window to consider equities investments. On the other hand, those who have put too much weight on stocks should have learned their lessons on the need for diversification and the reality of market corrections. Many individuals who missed on the current bull run and who were mainly in fixed income instruments can now take advantage of this correction. They will now have a chance to have an equity component in their portfolio by slowly accumulating stocks or by buying into an equity mutual fund.

We advocate that one should play for the long-term. For one, this is to match the long-term nature of most financial goals. For another, short-term investing or punting significantly raises one's risk of being whipsawed amid market volatilities. Lastly, a long-term outlook gives us a better perspective on the market and enables us to view market downturns not as setbacks but buying opportunities.

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