THE STOCK MARKET GAME™

IN THE NEWS

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Allocation in Balance

By Vincent Young

What's the longest time you've had to wait for something? A few hours? A day? Several weeks? Months? A year? Several years? What was it and why were you willing to wait to get it?"

Time Horizon

In investing, the length of time you are willing to wait to use the money that you have invested is called your **time horizon**. If you plan on waiting just five years or less, most financial professionals would consider it to be a short time horizon. If you plan to wait 10 or more years before using your money, it's considered a long-term time horizon. An intermediate time horizon would be somewhere in the middle, between five and 10 years.

In most cases, the further away you are from your time horizon, the more risks you can take with your investments. Investors willingly make risky investments because they hope to earn higher returns. Risk is the possibility of your investments losing money. "Returns" refers to the money your investment earns.

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The example that is often given is the comparison between an older person, who is near retirement or ready to stop working, and a young person just starting out in a job or career. The assumption is that the younger person has a longer time horizon so they can pursue potentially higher returns by making riskier investments.

If the young person's investments experience losses, they have the time to recover. The older person who is typically near retirement does not have the time to do this.

Asset Allocation

Investors diversify their investments (meaning they invest in an assortment of companies from a variety of industries) to reduce the losses that may result from risky investments. To help manage their risk, they also invest in different assets. An asset can be a stock, bond, or mutual fund. Your **asset allocation** refers to how much each asset in your portfolio contributes to your portfolio's total returns. It is usually noted as a percentage.

For example, your portfolio can be made up of 60% stocks and 40% bonds. Your portfolio can also be divided up further. You can decide to have 50% of your portfolio invested in stocks, 20% invested in bonds, 20% in mutual funds, and leave 10% as cash. Most investors determine their asset allocation based on their time horizon and their risk tolerance. Risk tolerance refers to how comfortable an investor is with taking financial risks.

Strategic & Tactical

Knowing your time horizon and risk tolerance will help you figure out the most effective asset allocation for you. If you have a long time horizon and plan to buy and hold your investments, a **strategic asset allocation** plan may work best for you. The term "buy and hold" means you intend to keep the assets you have bought for a long time even if their prices begin to drop. You "hold" on to these assets with the belief that their prices will rise again. Strategic asset allocation is considered a "passive" plan, meaning investors don't trade often.

If you have a short or intermediate time horizon and prefer to trade the assets in your portfolio frequently, you might choose a **tactical asset allocation** plan. A tactical asset allocation plan is the opposite of "buy and hold." A tactical asset allocation plan is "active," meaning investors are constantly looking out for profitable investment opportunities and buying and selling to improve their portfolio's returns.

Rebalance

Over time, your asset allocation will change because the value of your assets will fluctuate (their prices will rise and fall). For example, if the asset allocation you began The Stock Market Game™ with is 60% stocks and 40% bonds and your stocks earned a large return, your asset allocation might now be 70% stocks and 30% bonds because your stocks now represent a larger percentage of your portfolio's value.

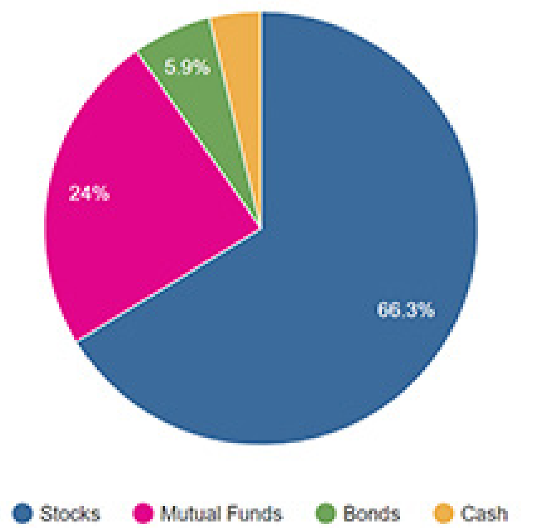

FIGURE 1: In discussions about asset allocation and rebalancing you might see or hear the term "weighted." In investing, "weight" refers to the portion of your portfolio made up of a specific asset or asset type. It is usually written as a percentage. To figure out the weight of an asset in your portfolio divide the dollar value of that asset by the total dollar value of your portfolio and then multiply by 100 to get the percentage.

Stocks are considered to be riskier investments than bonds. A larger percentage of stocks in your portfolio means you have more risk than you planned. To reduce this risk, you need to **rebalance** your portfolio. This means selling some of your stocks to bring down their percentage in your portfolio and purchasing more bonds to bring their percentage up. The goal of rebalancing is to bring your portfolio's asset allocation back to what you originally decided it should be.

Stock prices fluctuate frequently. This means your asset allocation may change frequently too. However, just like you pay commissions and fees inThe Stock Market Game, the costs of trading a lot in the real world can be high.

Financial professionals have different opinions about how often you should rebalance your portfolio. Some recommend you set a time to rebalance your portfolio. For example, once every three months (quarterly) or every year (annually). Others believe you should rebalance your portfolio when your asset allocation changes by 5%.

You devote time to researching and selecting the assets to include in your portfolio. To figure out your asset allocation plan, you spend time reflecting on your risk tolerance and time horizon. Rebalancing helps ensure that the thought, time, and effort you've put towards developing your portfolio will provide you with the returns you anticipate.

TO THINK ABOUT

1. Assuming portfolios holding a large percentage of stocks are risky, how would you rebalance the portfolio in **Figure 1** so it is less risky? What would you buy? What would you sell?

2. Visit the Account Holdings section of your Stock Market Game portfolio. How is your portfolio currently weighted? In your opinion is it a risky portfolio? How would you rebalance it so it is less risky? Use examples of assets you would trade.