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Asset allocation: It's meaningless unless you've defined your investment goals

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You can't make any worthwhile decisions about asset allocation without knowing why you are investing in the first place.

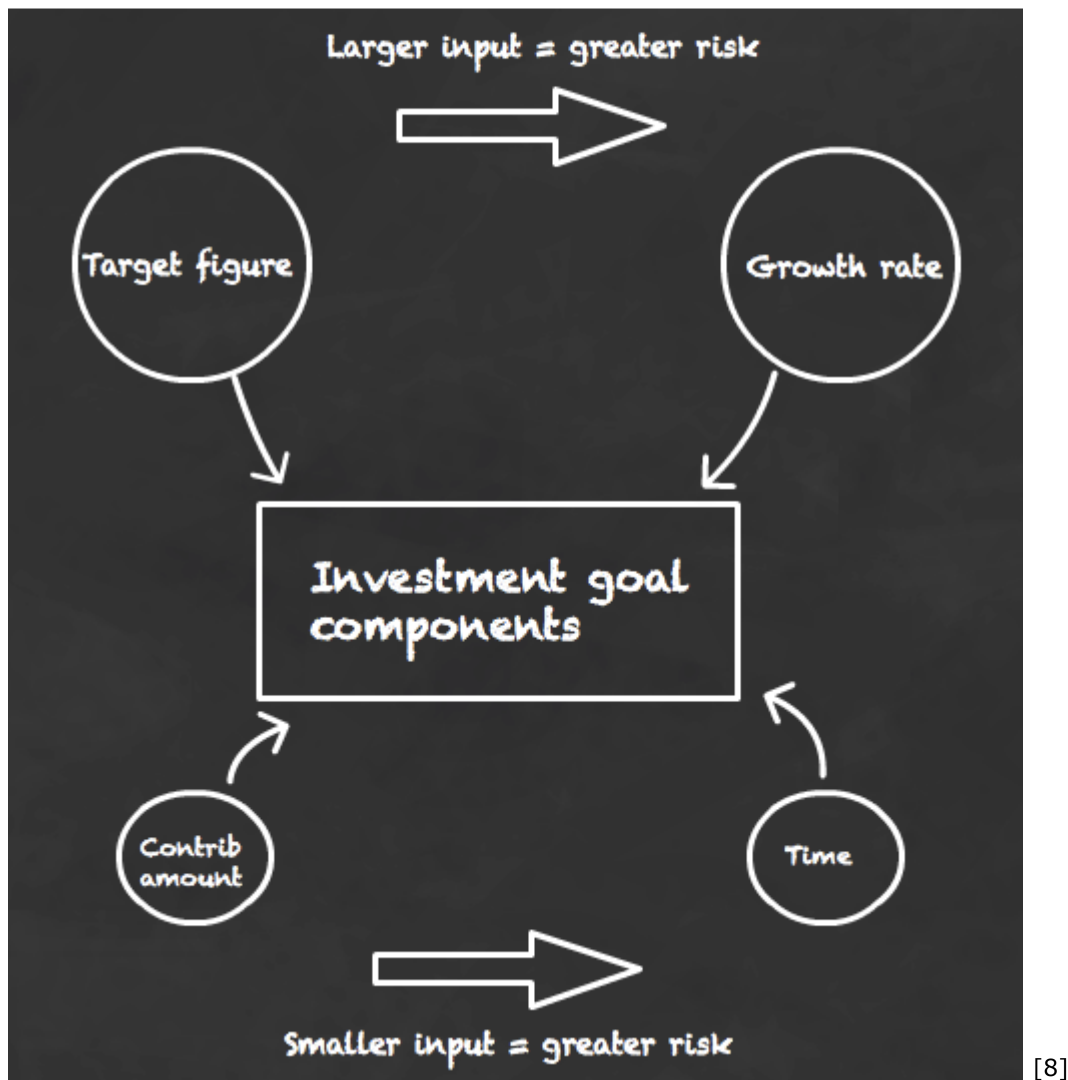
What do you want to achieve? What, in a nutshell, are your investment goals [1]?

Asset allocation [2] is the art (not the science) of putting together a portfolio [3] of investable assets that gives you the best shot of meeting your goals.

The blend of assets you require will be determined by the magnitude of your investment goals and the answers to two further key questions:

How much risk [4] do you need to take? If you sit tight in low risk, low growth assets, the big danger is that you never reach your goal. Equally, if you've already amassed enough wealth to meet your needs, then why keep dicing with Mr Market? As passive investing [5] guru William Bernstein puts it: *"If you've already won the game, there's no need to continue playing."*
How much risk you can handle? If your goals require you to take big chances with risky assets but you have the financial stomach of a cowardly lion, you're liable to bite off more stress than you can chew.
Pinning down your personal risk tolerance [6] is extremely difficult – you won't really know how much you can handle until you've experienced a **damn good shoeing** in the market. That's why many people use rules of thumb [7] to guide their asset allocation.

However, you can estimate the risk dosage you need to take by chunking down your investment goal into its component parts.



[8]

Owning the goal

Common investment goals are retiring early (or just retiring at all), paying off the mortgage [9], sending the kids to university [10], building a rocket ship to reach Alpha Centauri, and so on.

It's also normal to start investing on the vague notion that you'd rather like to be rich(er).

Normal but dangerous.

The problem with a fuzzy goal is that it's all too easy to abandon. There is no yardstick of success to keep you on track, and the plan can quickly be forgotten when disillusionment pays a visit.

Defining your plan with a few numbers helps to set it in concrete. It enables you to **rationally assess** the significance of the setbacks you meet along the way. And it creates a strong anchor point to cling to when the going gets tough, as it inevitably will.

Breaking down your investment goal

The key components of any investing goal are:

Vision – For example, *"I want to retire at 55."*
Target – What is the number in pounds and pence that you need to achieve?
Time horizon – How many years can you take to hit the target?
Contribution level – How much can you invest? This may be a lump sum or a regular amount, such as £250 a month.
Expected rate of return – What growth rate do you need for your contribution to mushroom into your magic number, given your time frame? You'll need to come up with a credible expected return [11] for your portfolio – and come to terms with the fact that expected returns are not guaranteed.
The good news is the vision is no more than a sentence. The numbers, too, are much easier to estimate than they first appear.

It's also important to appreciate that – like planets exerting gravitational pull – the components of your investment goal directly influence each other.

When reality intrudes

You can use these relationships to try to solve any problems with your plan.

Can't hit your target number within the time [12] you've got left to invest? Then accept that you must reduce that target, or increase your contribution rate.

Can't reduce your target figure or increase your contribution rate [13]? Then maybe increasing your time horizon will square the circle.

Another solution is to **increase your expected return**, but you must beware of straying into the realm of fairy tales. If you want to be the master of your own destiny then you should only tweak the components you can control.

Doing your homework

The relationships between the moving parts of your investment goal become blindingly obvious when you use a financial calculator [14] to help you work out the numbers.

Playing with the components of your investment goals is a valuable exercise as it enables you to:

See how realistic your goals are and how much you'll need to save [15] to achieve them.
Estimate how much growth you need over how long a period. (The less growth you need, the less risk you need to take. The less risk you can handle, the longer you'll need to invest – or the more you'll need to invest to hit a given target).
Use that data and knowledge of asset class characteristics [16] to tailor an asset allocation that takes into account your own need and ability to handle risk.
The process of defining an investment goal and adjusting it to suit your financial reality best slots into place when you work through a practical example.

To that end, we've previously shown you how to do that for retirement [17] – the most

difficult investing challenge most people will face. Go have a look!

Take it steady,

The Accumulator

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