The Financial Advisor's Guide to Asset Allocation

I had a financial advisor reach out to me recently with some questions about implementing some changes to his firm's asset allocation models. It served as a good reminder about the importance of asset allocation in the investment process. Few investment decisions matter more than asset allocation but many investors choose to focus their attention elsewhere.

In the past, many brokers or financial advisors didn't spend much time worrying about asset allocation because they were so focused on security selection and selling products. After speaking with this advisor I made some notes and here's what I came up with for the financial advisor's guide to asset allocation.

A perfect allocation is the enemy of good allocation. There's no such thing as a perfect portfolio, rebalancing interval, tax deferral strategy or investment mix. The perfect allocation will only be known in hindsight. In the grand scheme of things, it won't matter much if you have 5% or 10% in a certain fund or asset class. Half the battle is having a plan in the first place. There are no right or wrong asset allocations for your clients but there are a number of things to consider:

- Which asset classes, sub-asset classes, and strategies will you use?
- Will you practice a strategic allocation, a tactical allocation or a combination of the two?
- What will you own and why?
- What won't you own and why?
- When will you decide to make changes and why?
- How will you implement your plan and how much maintenance will be required?
- Which types of funds or securities will you use to gain your desired exposures?

You have to be able to explain it. Since there is no perfect asset allocation, you must be able to explain to your clients which types of investments you'll be putting them in and why. Any number of strategies will perform just fine if you leave them alone but if your clients can't understand how they work or why they own certain investments it's going to be difficult to get them to stay the course over time. Simplifying complex topics is one of the more underrated roles of being a good financial advisor.

Ongoing education is key. To create useful portfolio allocations you have to understand your clients and they have to be able to understand you. Portfolios shouldn't be designed for simulations, but for the people who will be investing in them. Education on asset allocation is all about setting the right expectations, teaching about market history, conveying the present while preparing clients for the future. The teaching and communication process never stops.

Some educational considerations:

- What's the best way to explain your investment philosophy and individual strategies?

- Do you understand your investments enough to explain them?
- Can you put it in simple enough terms that people outside the finance world can understand it?
- How do you plan to communicate going forward to ensure clients stick around long enough to see it through?

Understand your risk factors. Asset allocation is about diversifying your risks, but you first have to define what those risks are before creating portfolios. Diversification is never going to completely eliminate risk but asset allocation can help you manage it. It's not so much the individual asset class or fund risks that matter as much as how they all work together to create or reduce overall portfolio risk. Historical relationships and correlations are constantly changing over time so the goal should be to have several assets that will act differently than one another without becoming overly-diversified (the law of diminishing returns can come into play here).

A few more considerations:

- What's the most efficient way to own the specific asset class or risk factor you're looking to gain exposure to?
- Do you understand the right risks to prepare for?
- What's a reasonable cost to pay for those exposures?
- How do you balance the short-term sanity of your clients with their long-term goals and needs?

Asset allocation is hard. It can be challenging to come up with a long-term allocation policy, implement it and then have the discipline to stick with it. Asset allocation is a simple concept yet it's extremely difficult to see through in real time because (a) there will always be something in your portfolio you hate at the moment, (b) there are tons of temptations and distractions from other investors, the markets and investment products and (c) long-term policies tend to get thrown out the window at the height of a strong bull market or the depths of a severe bear market.

Creating good policies and then following through with them increases your odds of success exponentially but it's not easy exhibiting this type of behavior. This can be even harder when you're dealing with other people's money. What you want investors to do versus what they can reasonably be expected to do are two very different things.

Some final considerations when thinking about a client's asset allocation:

- You should have a very good reason any time you make a change to a well thought out asset allocation policy on behalf or your clients.
- The majority of the time, doing nothing is the best decision you can make.
- Knowing your clients is extremely important because you can't simply fit every single one of them in the same allocation mix.

- The best allocation is the one you (and your clients) will stick with.

You also have to remember that we always live in uncertain times. Asset allocation is how you manage your money without knowing what the future holds. Asset allocation is for long-term people.

Further Reading:
7 Simple Things Most Investors Don't Do