

# Evaluating asset allocation after the crash

When nothing goes as planned, should you change the plan?

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Asset allocation<sup>1</sup> is the heart of a sound, long-range investment plan - a strategy that helps investors avoid the natural instinct to react to fear and over-optimism, which can defeat efforts to build wealth. However, recent market events are testing even the most resolute investors. It is tempting to take action. The temptation to change asset allocation is strengthened by two key factors:

- 1) Perhaps the world has changed in terms of the risk/reward tradeoffs available in financial markets.
- 2) Events in financial markets and the overall economy have materially changed your clients' circumstances so much that a current allocation may no longer be appropriate.

The challenge is to help clients evaluate the logical reasons to change their allocation against natural instincts to react emotionally.

## SO HAVE THE MARKET RISK/REWARD EXPECTATIONS CHANGED FUNDAMENTALLY?

We believe the long-run risk/reward tradeoffs of financial markets haven't changed, nor have the expected returns of major asset classes. We also believe that increases in volatility and correlations among asset class returns driven by the financial crisis are transitory.

What may have changed, though, is an investor's ability to meet their goals due to the sharp market decline. With this in mind, as you work with your clients, focus on analyzing how reductions in wealth and possibly diminished earnings prospects could reduce future saving and may require asset allocation adjustments.

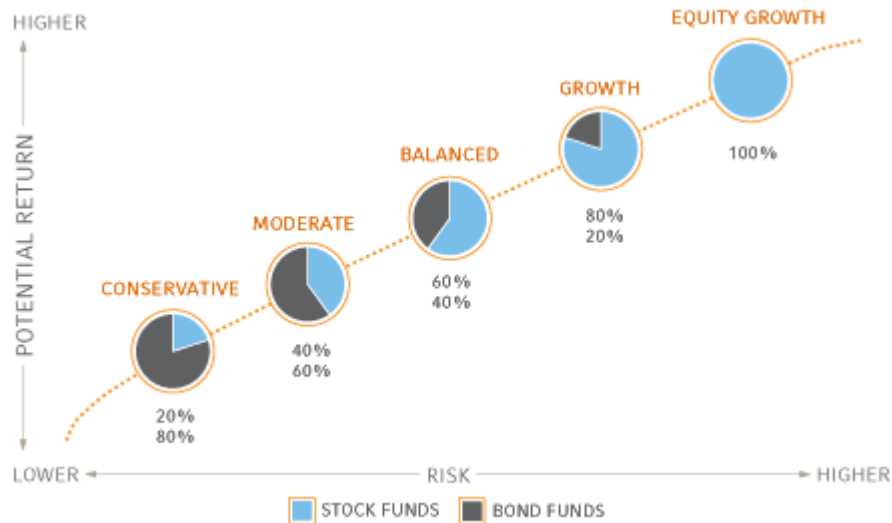
## WHAT FACTORS SHOULD YOU CONSIDER BEFORE SUGGESTING ANY CHANGES IN ASSET ALLOCATION?

To determine whether the recent market turmoil should drive a change, here are factors to consider.

The traditional process for setting an asset allocation focuses on the efficient frontier. Each point along the efficient frontier is associated with a portfolio allocation that gives the greatest reward for a given amount of risk (see Figure 1). The efficient frontier, along with a risk tolerance questionnaire, helps determine which portfolio to choose.

<sup>1</sup>Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Figure 1: Asset-allocated portfolios along the efficient frontier



As you move from left to right on the graph—increasing risk—there are investments that can offer higher return potential. However, as with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

At Russell, we recommend going a step further to put your clients' needs at the heart of their asset allocation. Besides the risk tolerance questionnaire, create an adjusted, accurate asset allocation by factoring in the investor's current wealth, age and spending plan. And if the investor is still saving, allow for the number of years left to save before retirement.

### WHAT SHOULD RETIREES OR CLIENTS NEAR RETIREMENT CONSIDER?

If your clients are retired or within three to five years of retirement and have experienced a significant reduction in wealth, it's time to reconsider their asset allocation. Advise clients who are retired and risk running out of money to reduce portfolio risk and consider reducing spending.

Retirees who are spending at higher levels can reduce their spending to fit their reduced wealth and current allocation. They may need an asset allocation change if they prefer to maintain their current spending.

For retirees and those within five years of retirement, staying the course makes sense if their spending plan was conservative and they're still very likely to have enough money to live on. Retirees in this position may still have a long time horizon and are essentially investing to preserve their estates.

### WHAT SHOULD INVESTORS WHO HAVE MORE TIME UNTIL RETIREMENT CONSIDER?

Investors who have three to five years or more until retirement are usually less affected by shorter-term portfolio losses for two reasons. First, they have a longer-time period to wait for the market to recover before withdrawing money from their portfolios. Second, future savings and returns on those savings help dilute the effects of earlier losses. Under these two conditions, investors are less likely to need to reduce their portfolio risk in response to severe market downturns.

But the closer to the three- to five-year retirement mark investors are, the less insulation they may have. If a change is warranted, first consider actions besides reducing portfolio risk. Unless recent events have reduced investors' prospects for earning and subsequent saving, extending the anticipated retirement date substantially improves the

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likelihood they'll maintain their spending plan. Another option is to reduce retirement spending goals. Since increased saving and reduced spending directly affect the assets in a portfolio, they offer more controllable ways for investors to respond to challenging market environments.

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