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Building a portfolio (3)

Asset allocation and the "Age Guide"

After working out what investment might be suitable for you, and in particular your attitude to risk, you need to think about the spread of funds, or asset allocation.

There are a number of approaches to the make-up of a portfolio and ***asset and geographical split.***

Increasingly computer models have been used to create the chimera of a rational structure. But these tell you nothing of the "accidents of history", such as the extreme events of 2008. They lack the insight that only experienced practitioners can provide.

Obviously you must start by having a comfortable sum on deposit or similar, that is with no risk to capital – to cover emergencies, planned expenditure, and peace of mind.

With the rest of your investments, as you get older you will typically want to adjust the balance, with more in lower risk choices (e.g. bonds and property), and less in stockmarket linked investments. This is quite natural.

As such our approach is to use the "age guide" as a starting point. This enables us to split with investments into three "risk buckets".

In a nutshell the age guide means that the lower risk part of your portfolio (the low risk bucket) matches your age e.g. a 60 year old should have 60% in the low risk bucket.

This approach has the following benefits:

- It is understandable
- It matches most investors' common sense view of how their attitude to risk will unfold with age
- It ensures that the portfolio is diversified, as each of the risk buckets that make up the portfolio is spread across different asset classes, with varying degrees of risk and reward
- It creates a structure within which ongoing reviews are straightforward

Nonetheless, this is only a rule of thumb, giving a structure for consideration.

For example, it may be too cautious for some if you have a secure and more than adequate guaranteed pension.

On the other hand personal circumstances and your attitude to risk may make this cautious guide just right for you.

The vital component of the model portfolio is the fact of the risk buckets rather than the precise amount in each risk bucket. Whether a 50 year old has precisely 50% in lower risk is not vital – this is art not science.

The application of the age guide means that although the investor will more often than not have an attitude to risk such that they are comfortable with medium risk investments, the actual portfolio will have a notable exposure to lower risk investments, **resulting in a portfolio on the relatively cautious side.**

In Part 4 we define the risk buckets, and what we mean by low, medium, and high risk.