how much Stock should be in your portfolio?

financial fitness

By **Rocky Mills**, North Ranch Resident

Answer These Four Simple Questions

Everyone talks about "asset allocation" – spreading around your assets into different buckets in order to reduce risk. At the highest level, it comes down to how much you put in stocks and how much you put in non-stocks (such as bonds, real estate and cash). But how much stock should be in your portfolio? In other words, given that stocks generally carry the most risk in a portfolio, how much risk should you be taking?

It's certainly not "one size fits all." Because everyone's financial situation is different, the right amount of stocks for you will vary, too. In general, you can apply these concepts:

- Younger investors can afford more stock risk than older investors
- Clients with higher income can afford more stock risk
- Clients with a greater net worth can afford more stock risk
- Clients who understand and desire more risk can incorporate this into their mix

How do you translate these concepts into a specific allocation to stocks (such as 60% or 75%)? For years, Financial Advisors have used "Mean Variance Optimizers (MVO)" to generate the answer. An MVO is highly sophisticated software that considers how each asset class has performed and how much it has moved relative to all the other asset classes. The MVO also uses assumptions for inputs like interest rates, inflation and mortality. In short, the Financial Advisor loads the MVO with client-specific data (age, income, net worth, risk tolerance) and the MVO spits out an allocation.

After using and studying MVOs for years, I've concluded:

- An MVO's outcome (say, to ideally have 55% in stocks) is still only an approximation.
- In fact, you can vary this number up or down about 7% and not significantly alter your long term outcome. So this 55% single-number outcome becomes a range of 48% to 62%.
- It takes lots of client and Financial Advisor time to complete the MVO process.
- Clients generally have no idea how their inputs affected the MVO's outcome.

Is there a back-of-the-envelope way to approximate an MVO's output? Borrowing from online asset allocation sites (like the one used by the SEC1), I use these four simple questions. Simply add these four components together to reach your ideal stock percentage:

1. What is your age? Subtract that from 100.
2. Does your income exceed your expenses? If so, add 10.
3. Does your net worth exceed $3 million? If so, add 10.
4. What is your risk "personality"? This is not asking your opinion about the stock market; it is not asking you to consider your age or financials. This simply reflects your feelings about taking a risk.
   - If you're a "bury it in the mattress" type, subtract 10.
   - If you're a "bet it all on #7 red," add 10.

I have yet to run across a -10 or a +10. Most clients range from -5 to +5, and average around 0.

So let's try an example – me:

1. I'm 65. So I start with 35 (i.e. 35% in stocks).
2. My income exceeds my expenses, so I add 10. I'm now at 45.
3. My net worth exceeds $3 million, so I add another 10. That brings me to 55.
4. I understand risk very well. I'm not a gambler, but I'm willing to take a measured dose of risk. I'd score me at +3. Final total: 58.

The percentage of stocks for my accounts, then, should be somewhere near 58%. Given the +/- 7% range, my stocks ought to be anywhere from 51% to 65%. Of course, this is only an approximation – use of an MVO and other tools will get you a lot closer. And that's an average stock percentage. As I've discussed in other columns, I urge you to become TrendWise and vary your stock percentage as long-term market trends change.

1 The SEC's "Beginners' Guide to Asset Allocation, Diversification, and Rebalancing" suggests using the calculator at **http://www.ipers.org/calcs/AssetAllocator.html**

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