Vanguard

Vanguard's principles for investing success

Asset allocation

There's no guarantee that a type of asset doing well this year will do well next year. It's pretty hard to predict what's going to happen next, even for investment professionals.

When it comes to investing, it can be hard to see a pattern.

Quite often the best performing investment one year can appear as one of the worst the following year.

Develop a suitable asset allocation

A sound investment strategy starts with an asset allocation suitable for your portfolio's objective. The allocation should be built upon reasonable expectations for risk and returns, and should use diversified investments to avoid exposure to unnecessary risks.

Both asset allocation and diversification are ingrained in the idea of balance. Because all investments involve risk, you need to manage the balance between risk and potential reward through the choice of your portfolio holdings.

The importance of asset allocation

When building a portfolio to meet a specific objective, it is critical to select a combination of assets that offers the best chance for meeting that objective, subject to your constraints.

Assuming you use broadly diversified holdings, the mixture of those assets will determine both the returns and the variability of returns for your aggregate portfolio.

Equities are risky – and so is avoiding them

Equities are inherently more volatile than investments such as bonds or cash instruments. This is because equity owners are the first to realise losses stemming from business risk, while bond owners are the last.

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In addition, whereas bond holders are contractually promised a stated payment, equity holders own a claim on future earnings. But the level of those earnings, and how the company will use them, is beyond your control. Investors thus must be enticed to participate in a company's uncertain future, and the "carrot" that entices them is higher expected or potential returns over time.

Why not simply minimise the possibility of loss and finance all goals using low-risk investments?

Because the attempt to escape market volatility associated with equity investments by investing in more stable, but lower-returning, assets can expose a portfolio to other risks.

One such risk is "opportunity cost". When a portfolio lacks investments that carry higher potential returns, it may not achieve growth sufficient to finance ambitious goals over the long term. Or it may require a level of saving that is unrealistic, given more immediate demands on the investor's income or cash flow.

Another risk is inflation. A portfolio comprised of investments carrying lower potential returns may not grow as fast as prices rise, so an investor would lose purchasing power over time. For longer-term goals, inflation can be particularly damaging, as its effects compound over long time horizons.

For investors with longer time horizons, inflation risks may actually outweigh market risks, often necessitating a sizeable allocation to investments such as equities.

Use reasonable assumptions in choosing an allocation

Just as important as the combination of assets used to construct a portfolio are the assumptions used to arrive at the asset allocation decision.

By this we mean using realistic expectations for both returns and volatility of returns. Using long-term historical data may serve as a guide, but keep in mind that markets are cyclical and it is unrealistic to use static return assumptions.

History does not repeat, and the market conditions at a particular point in time can have an important influence on your returns.

Diversify to manage risk

Diversification is a powerful strategy for managing traditional risks. Diversifying across asset classes reduces a portfolio's exposure to the risks common to an entire class. Diversifying within an asset class reduces exposure to risks associated with a particular company, sector, or segment.

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In practice, diversification is a rigorously tested application of common sense: Markets will often behave differently from each other—sometimes marginally, sometimes greatly—at any given time.

Owning a portfolio with at least some exposure to many or all key market components ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas.

The key take-away

Asset allocation and diversification are powerful tools for achieving an investment goal. A portfolio's allocation among asset classes will determine a large proportion of its return—and also the majority of its volatility risk. Broad diversification reduces a portfolio's exposure to specific risks while providing opportunity to benefit from the markets' current leaders.

Performance leadership is quick to change, and a portfolio that diversifies across markets is less vulnerable to the impact of significant swings in performance by any one segment.

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ACEA4_122019