Actual Versus Target Asset Allocation

You should compare your portfolio's performance against predetermined target benchmarks.

We have already covered a few useful benchmarks.

Arbitrary return figures such as nil, the risk-free rate, or a required rate of return based on your needs.

Relevant publicly available indices that reflect the composition and risk of your actual portfolio.

If investing in funds, comparing your portfolio returns and expenses against the funds' peers.

There is one other important benchmark that we have not yet covered.

Comparing your actual portfolio against your target asset allocation.

We will look at this today.

Target Asset Allocation

Your target asset allocation should be derived from your Investment Policy Statement (IPS).

It should factor in your personal circumstances, investment objectives, personal constraints, risk tolerance, and so on.

As your situation changes over time, your target allocation will shift as well. But changes should be made only when material events occur in your life (i.e., something major like marriage, children, career change) or when you move through phases of your life cycle. Alterations to one's target asset allocation should not be an annual activity for most

investors.

Actual Versus Target

Some experienced investors may compare the expected returns of their target asset allocation to the actual results. This can be done if you can assign expected returns to each asset class. But it is beyond our area of discussion at this time.

Instead, compare your actual asset allocation against your intended allocation. It will not likely be the same.

The reason is that your portfolio will probably earn some income in the form of dividends or interest. You may also buy or sell investments from existing liquid assets. These will all impact your cash component.

As well, you will incur unrealized gains or losses on your investments. These changes will affect your actual allocation.

For example, you invested $10,000 on January 1. Your target asset allocation was 60% global equities and 40% in mixed bonds. So you acquire 150 shares of Vanguard Total World Stock Index ETF (VT) at $40 per share and 400 units of ING Global Bond W Fund (IGBWX) at $10 per unit. At year end, you review your portfolio and find that the VT shares are worth $50 each and the IGBWX fund is worth $8 per unit.

Although you did not buy or sell any shares or units during the year, your portfolio allocation now sits at 70% equities and 30% bonds. Suddenly, you are out of alignment with your plans.

Good or Bad?

When comparing your actual portfolio performance against an index, peer, or arbitrary value, the higher your performance the better.

But in comparing your portfolio against the target allocation,

the less variance the better.

Ideally, you would like your actual portfolio to maintain its target ratio as long as possible. But this is not realistic. And if you have a well-diversified portfolio, it is pretty certain that your allocation will differ.

Why? Because a well-diversified portfolio should see some assets increasing in value and others falling as they act as hedges against each other’s movements.

So your objective in this analysis is to monitor your portfolio and make sure that it stays within a certain range of your target asset allocation.

Target Range

Range?

Yes, range.

To the extent practical, you want to maintain a buy and hold investment strategy. But if you want to ensure a fixed ratio of 60% stocks and 40% bonds, then you will need to rebalance constantly.

In our example above, that might mean selling $1080 of VT and purchasing additional units of IGBWX with the proceeds. That works for now. But what about the next review? What if stocks have fallen in price and bonds have increased? You might find that your VT shares are only worth 50% of your total capital. Then you need to sell some bonds and buy some more VT. And the next review, things may change again.

Not a formula for successful investing.

Instead, use ranges for your target allocations. Maybe you desire a 60-40 split between stocks and bonds. But create a comfort zone to prevent frequent adjustments. Perhaps your target can be 55-65% stocks and 35-45% bonds. Or 50-70% stocks

and 30-50% bonds.

That will give you some leeway during your reviews, thereby prevent continuous adjustments with the attendant transaction fees and capital gains taxes.

The range you select should reflect your individual tastes. Your investor profile, personal risk tolerance, and ongoing review experience will play a large part in how wide the ranges are.