Age and risk tolerance key to mastering asset allocation

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Ilana Polyak, special to CNBC.com March 3, 5877521

Part art, part science, asset allocation is the mix of a portfolio's stocks, bonds and other investments that can help it meet a particular goal. In an oft-cited study, Brinson, Hood and Beebower noted that asset allocation—not investment acumen or market timing—accounts for more than 90 percent of an investment's return.

Asset allocation is supposed to limit the downside by spreading risk around. When some asset classes falter, others rise, the thinking goes.

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But in the 2008–09 market rout, even the most diversified portfolio took a beating as all asset classes sank in tandem, and it took many years to recoup those losses.

Many investors responded by retreating out of stocks. It took them many years to tiptoe back in.

"You need to think about the asset allocation that's going to keep you invested over the long term," said Robert Stammers, director of investor education at the CFA Institute.

Your age may dictate your asset allocation. But you need to temper it with your own investment behavior, Stammers said.

Building blocks of asset allocation

The main difference between aggressive and conservative portfolios comes down to the balance between stocks and bonds. There's little difference between the stock portfolio of a 20-something and that of a retiree, other than the amount of stocks each owns.

Within equities, financial professionals urge investors to make sure to diversify among domestic and international stocks, since they often move in opposite directions. Also include small- and large-cap stocks to capture the performance of different company sizes.

But investors don't need to slice their equities too thinly with alternative investments. "Alternatives are very confusing, and even a lot of advisors aren't that familiar with them," said Dory Rodriguez, wealth advisor with HighPoint Planning Partners.

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Real estate is an exception, and many financial advisors recommend 5 percent to 10 percent allocation toward real estate investment trusts in most portfolios. However, REIT dividends are taxed as ordinary income, so hold them in tax-sheltered accounts, such as 401(k) plans and individual retirement accounts, to avoid the tax hit.

When it comes to bonds, a mix of corporate, Treasury and high-yield bonds diversifies across industries and interest-rate exposure.

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Decade by decade

Below are the recommended asset allocations for investors saving for long-term goals at different ages.

20s to 30s: The conventional wisdom holds that people in their 20s and 30s can load up on risk because they've got plenty of time to ride out inevitable rough patches. Many advisors recommend all-stock portfolios for this demographic.

But not every young investor can stomach what the market dishes out. In fact, millennials—the generation born between 1982 and 2004—are decidedly skittish when it comes to stocks. According to personal finance website Bankrate.com, just 26 percent of people under 30 own stocks at all.

That's why certified financial planner Joe Pitzl, a partner with Pitzl Financial, believes young investors may need to ease into stocks. "If you take that extra risk early on and scare them so they never take that extra risk in the future, then you've done them a disservice," he said.

For nervous investors, Pitzl suggests a 60 percent stock allocation with the remainder in bonds, staying with this mix through an entire market cycle. He wants investors to experience the euphoria of bull markets and the misery of bear markets. "It lets them become comfortable with stocks, and then later on I might move them toward 70 [percent] to 80 percent," he said.

40s to 50s: In middle age, you're likely hitting your peak earning years, though your financial commitments may be peaking, too (e.g., college tuition … need we say more?). Some investors may feel comfortable with a big dose of equities, but others might want the added stability that bonds provide.

"If you save well and have put money away, then you can probably invest in less risky investments," said Stammers of the CFA Institute. "It's the people that wait until their 40s and beyond that really have to dial up the risk."

Jesse Abercrombie, a financial advisor with Edward Jones, recommends a portfolio of 60 percent in stocks and 40 percent in bonds, though those with a greater risk appetite can go higher in equities.

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Given today's near record-low interest rates, Abercrombie cautions investors to stay at shorter maturities for bonds and put some money in high-yield bonds, which are less sensitive to rate hikes.

"Asset allocation is going to change over time," he said. Be prepared to make changes when your investments veer 10 percent to 20 percent away from your original allocations through rebalancing. "Look at areas that are undervalued, and look to allocate more there," he added.

60s: Financial advisors used to recommend taking 100 and subtracting your age to come up with the right stock allocation. This ignores advances in longevity and the need for greater growth at later ages, noted Stammers.

"Now we're saying that it's more like 120, because you'll still need the return engine," he said.

For someone in his or her 60s, that would mean a 60/40 portfolio of stocks and bonds. Those playing catch-up, though, might need to lean more heavily on stocks to power their savings. "I would tend to be higher on the equities, assuming you don't have a gold mine," said Philip Lee, a CFP with Modera Wealth Management.

> "Your portfolio has to last 30 years. If you significantly overweight fixed income, it will be difficult for your portfolio to preserve your buying power." -Joe Pitzl, partner at Pitzl Financial

But investors must balance their needs for growth and stability. A portfolio decline early in retirement can be devastating for many years to come, because you exacerbate portfolio losses with withdrawals. For that reason, if investors have a significant equity stake in their 60s, Lee recommends pairing it with a home-equity line of credit that can temporarily be used for cash needs if a portfolio is down.

"Do it while you're still working and can qualify," he said. "Yes, [the bank] may deduce that you're going to retire next couple of years, but if you can produce a W-2, you should be able to get one."

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70s and beyond: It's tempting to think that your asset-allocation decisions are done now that you're retired. Hardly. Even at retirement, your need for growth is great.

"Your portfolio has to last 30 years," Pitzl said. "If you significantly overweight fixed income, it will be difficult for your portfolio to preserve your buying power."

By the same token, retirees need stability. An evenly split portfolio between stocks and bonds is reasonable, advisors say.

To provide stability, advisors recommend a bucket approach. Put a few years of needed income in short-duration bonds to fund your spending. The rest can be invested for growth; you can replenish your spending bucket when markets are up. And if they're down, you've got enough cash on hand to ride out the storm.

—By Ilana Polyak, special to CNBC.com