Asset Allocation

Your Most Important Decision — Lesson Explainer

The Concept

Asset allocation is how you split money across broad categories - stocks, bonds, cash, alternatives. Research consistently finds this split explains the vast majority of a portfolio's long-term risk and return - more than which specific stocks you pick.

Stocks: higher expected return, bigger swings. Bonds: lower return, more stability. Cash: least growth, most stability. Blending them in different proportions produces a completely different risk/return profile.

There's no single 'correct' allocation - the right mix depends on your time horizon and risk tolerance (the next lessons in this section).

Illustrative Example: Three Model Allocations

Allocation	Stocks	Bonds	Illustr. Return	Illustr. Volatility
Conservative	30%	70%	~5.2%/yr	Lower swings
Balanced	**60%**	**40%**	**~6.8%/yr**	**Moderate swings**
Aggressive	90%	10%	~8.2%/yr	Larger swings

Same universe of assets, three completely different outcomes - purely from changing the split. Higher expected return comes paired with larger swings, not for free.

5 Things to Know About Asset Allocation

1. Allocation drives more of your outcome than security selection.

2. Higher expected return comes with higher volatility - the trade-off is real.

3. There's no universally 'correct' allocation - it depends on your time horizon and risk tolerance.

4. Allocation isn't a one-time decision - revisit it as your goals and life stage change.

5. Drift happens automatically - without rebalancing, winners grow to dominate your mix.

4 Things to Check When Setting an Allocation

• Start with time horizon - a longer runway generally allows more room for stocks.

• Be honest about risk tolerance - an allocation you can't stick with isn't the right one.

• Think beyond just stocks and bonds - cash and alternatives can play a role too.

• Plan to revisit it - allocation is a decision you'll periodically reconsider.

Worth knowing:
asset allocation is a framework for thinking about risk and return, not a formula with one right answer. Illustrative figures use simplified long-run assumptions for teaching purposes - actual results vary by period and by the specific assets held.

Quiz — Answer the questions, then check the key on the next page

1. What is asset allocation?

A. Picking which individual stock to buy
B. Timing when to buy and sell
C. How you split your money across broad categories like stocks, bonds, and cash
D. The fee a broker charges

2. What explains the vast majority of a portfolio's long-term risk and return?

A. Which specific stocks you pick within your allocation
B. How often you check your portfolio
C. Your broker's trading platform
D. The asset allocation split itself

3. Why does higher expected return typically come with higher volatility?

A. There's no allocation offering stock-like returns with bond-like stability
B. It doesn't - return and volatility are unrelated
C. Bonds always outperform stocks over any period
D. Volatility only affects cash holdings

4. Why isn't there one universally 'correct' asset allocation?

A. Because allocation doesn't actually matter
B. Because the right mix depends on your own time horizon and risk tolerance
C. Because regulators ban any specific allocation
D. Because stocks and bonds always move together

5. What happens to an allocation if you never rebalance it?

A. It stays perfectly fixed forever automatically
B. It's illegal not to rebalance
C. It quietly drifts as winners grow faster than laggards
D. Nothing changes regardless of market moves

Answer Key

1. What is asset allocation?

Correct answer: C. How you split your money across broad categories like stocks, bonds, and cash

Asset allocation is the split across broad asset categories.

2. What explains the vast majority of a portfolio's long-term risk and return?

Correct answer: D. The asset allocation split itself

The stocks/bonds/cash split explains most long-term outcomes - more than security selection.

3. Why does higher expected return typically come with higher volatility?

Correct answer: A. There's no allocation offering stock-like returns with bond-like stability

Higher expected returns come paired with larger swings - the trade-off is fundamental.

4. Why isn't there one universally 'correct' asset allocation?

Correct answer: B. Because the right mix depends on your own time horizon and risk tolerance

The 'right' allocation is personal, depending on time horizon and risk tolerance.

5. What happens to an allocation if you never rebalance it?

Correct answer: C. It quietly drifts as winners grow faster than laggards

Without rebalancing, strong performers grow to dominate the portfolio over time.