LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"Where the most money goes, risks go up and returns go down."
—Stock Market Axiom

The investment community generally acknowledges the importance of asset allocation. The percentage commitment to stocks and bonds is a powerful determinant of a portfolio's investment return and risk. Hence, one of the most important decisions an investor must make concerns the allocation between stocks and bonds in his or her portfolio. That allocation will be determined by many factors including: investment objective, tolerance for risk, and the length of time the portfolio is expected to be in place.

Changes in the asset allocation ratio over the life of the portfolio should be limited. Consideration should be given to changing the ratio if the portfolio owner's financial situation or objectives change. Additionally, in most cases, the ratio should become more conservative (greater emphasis on bonds and less emphasis on stocks) as the portfolio owner's age increases. Finally, an investor may find during a bear market that his or her risk tolerance was not as high as thought, resulting in some modification in asset allocation.

Stock and bond markets often move in opposite directions. As a result of this counter movement—relative to its stated asset allocation—a portfolio can easily become overweighted in one asset while becoming underweighted in the other. Many investors allow their portfolios to float with the market. The danger in this approach is that it assures overexposure at market highs to the asset class which is rising and under exposure at market lows to the asset class which is declining.

To counter the market's influence on the asset allocation ratio, it is necessary to engage in asset allocation management. This rebalancing of the portfolio means the selling of some portion of the asset class that experienced superior performance and replacing it with the asset class that experienced a relatively inferior return.

Unfortunately, many investors do not give rebalancing the attention it deserves. A big reason even many well-informed investors do not rebalance is that the concept is often counterintuitive. Human nature conditions us to believe that what has been working will continue to work and that failure is a precursor to failure. Rebalancing requires investors to sell portions of their portfolio when they are doing well in order to buy lagging investments that might do well in the future. People want to do what is comfortable. In investments, what is comfortable is rarely profitable.

It is important to resist the urge not to rebalance. Investors who sold stocks to buy more bonds during the late 1990s were eventually well rewarded. Today, the opposite may well be true. Remember, rebalancing keeps a portfolio's risk aligned with its owner's risk tolerance.

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