Ask a VR Intermediary

Eric Tyra
Owner, VR in Birmingham, AL

How Do I Manage My Investment Risk after the Sale of My Business?

Lisa Franklin
Aurora, Illinois

Dear Lisa,

Spreading assets over a variety of different investments is perhaps the most important rule you can follow. Because no single asset class performs best in all economic environments, the performance of a diversified portfolio is expected to fluctuate less as losses from some investments are offset by gains in others.

Asset allocation is the act of balancing the three common investment classes: Stocks, Bonds and Cash Reserves.

Common stocks, which represent ownership rights in a corporation, entail more risk than other types of financial assets in the short run. But over longer holding periods, they have usually provided the highest returns and the greatest margin over inflation. Common stocks also have the greatest potential for short-term downturns.

Bonds are IOUs issued by corporations, governments and federal agencies. They typically offer higher yields than cash reserves, but their value can fluctuate dramatically in response to changes in interest rates. Bonds generally offer higher current income with less volatility than stocks, but have limited potential for increased returns.

Cash reserves include money market securities such as Treasury Bills and short-term certificates of deposit. Because money market securities have shorter maturities, they typically provide a stable investment value and current interest income. However, inflation can quickly erode the purchasing power of cash, leaving investors short of reaching their financial goals.

Diversification within Asset Classes

As the stock or bond portions of your portfolio are refined, consider spreading investments among the various categories within a single asset class. For instance, diversification of the stock portion among several strategies to target growth stocks, value stocks, blue chip stocks and others.

A bond allocation may be diversified to include instruments characterized by specific maturities (short, intermediate, or long-term) or different types of bonds, such as U.S. government, corporate or tax-free municipal bonds. Also consider a mixture of domestic and international stock and bond investments.

What Should the Allocation Be?

How much emphasis should be placed on stocks for growth, bonds for income and cash reserves for safety and liquidity will depend in part on an investor's tolerance for risk and the time horizon for reaching financial goals. If the goal is the near-term purchase of a house or car, it may have a shorter time frame calling for lower- or moderate-risk investment approaches.

A goal like college education or retirement may have a longer time horizon that allows an investor to pursue more aggressive and potentially rewarding strategies because of the ability to wait out any short-term fluctuations in the market.

Of course, the time won't matter if you misjudge your emotional response to a downturn. For this reason, an investor must always weigh the desire for higher returns against a willingness to tolerate market setbacks.

Stay on Course

An effective asset allocation can help balance the risk assumed with the return earned. But it is still important to remember that the stock and bond markets are inherently volatile. All too often, investors become nervous at the first sign of a market downswing and may be tempted to alter their investment plan. By understanding what to expect, an investor will be able to stay on course and resist the urge to revise one's investment mix based on short-term market events.

To find out about asset allocation and how a customized asset allocation strategy may assist in reaching your financial goals, contact your financial advisor.