A PLAN FOR WEALTH ALLOCATION

We diversify among individual securities. We allocate our assets to different investment categories. We spread our funds across different products, both investment and insurance-based. But can we mentally separate our financial choices to allocate wealth for real-life scenarios?

Overview

Behavioral finance is a relatively new field that explores how humanbehavior and thought patterns influence our financial decisions and therefore, on a larger scale, our economy and financial markets. It's basically this: Human nature meets economic principles. What we have found through the study of behavioral finance is that people do not always behave rationally when addressing different market environments.[1]

For example, we may sell stocks when share prices drop in order to limit our losses, when it may make more sense to buy when prices are low. We are motivated to stock up on consumer products when there is a shortage even though we may have to pay much higher prices. In short, what we think and feel drives actions that may work to our disadvantage.

The practical reason for the study of behavioral finance is that we live in the real world. Our thoughts and actions are motivated by what's happening in our lives, so we don't always take a step back and think like an economics professor. When we need something now — be it money or peace of mind — we react quickly to get it. We do it to fix a short-term problem. We do it to alleviate stress. And we frequently do it without putting a lot of thought into how it might hurt our finances in the long run.

Wealth Allocation

Wealth allocation is a strategy that can help investors meld fundamental economic principles with the urgency of real-world problems. It's simply a way to stratify where our money is located so that when we feel the need to react, either to a financial emergency or to relieve financial anxiety, we know which accounts are best to tap for certain situations.

A wealth allocation strategy divides our net worth into three separate categories of financial goals, each with a representative risk level.

Safe Assets

Safe assets are the ones that aren't going to go away. These include cash savings, quality fixed income, our primary residence, Social Security benefits, guaranteed pensions and highly rated life insurance policies. The purpose of safe assets is to maintain our standard of living. However, they may not be able to sustain that level indefinitely. Early- and mid-career workers may have greater long-term needs, such as saving to buy a home, pay off debt, fund children's education and plan for retirement. Even retirees living on a fixed income should have a cache of additional funds available for an emergency.

The amount and location of safe assets will be different for each household, based on need. It's important to consider how long you may be able to sustain your lifestyle if you lost your current income. This means liquid funds available to pay for housing, food, transportation, health care and basic entertainment. Depending on your circumstances, how long would it take to restore your income — would you need six months of reserve living expenses? One year? Three years?

Growth Assets

Safe assets should be accessible for the here and now. The next step up is growth assets. This is money you tuck away for the future. Most people invest a portion of their income automatically through an employer-sponsored retirement plan, IRA or other type of vehicle, such as a personal portfolio of stock, bonds and/or mutual funds.

Growth assets are designed to grow over time, so they are not the first funds you'll want to tap if you need money. In fact, there may be a cost associated with having to tap these quickly, such as a capital loss, income taxes or an early withdrawal penalty. This money should be allocated to securities and asset classes that align with specific investor goals, the timeframe for reaching those goals and the investor's tolerance for market risk.

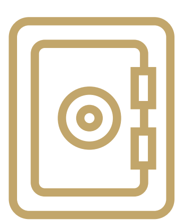
Ambitious Assets

For investors who either have sufficient funds in the first two categories, or need to allocate a portion of assets to higher-risk, potentially higher-reward options to make up for lost ground, the third wealth allocation category is for ambitious assets. In a sense, these assets are invested to "swing for the fences" in an attempt to make lots of money with a financial home run.

However, even in this category, investments should be balanced between risk and reward to reflect the asset owner's personal circumstances — and interests. In some cases, this could mean purchasing a higher stake in a concentrated sector or company stock. It could mean buying real estate for ongoing rental income and the opportunity for growing equity. It could mean purchasing mispriced securities for a long-term bet that they will reach their true value. The placement, and amount, of ambitious assets will vary among each investor, but the goal is the same: Above average investment success.

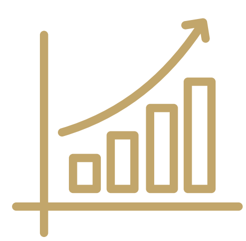
Note, however, that an investor should never invest more in ambitious assets than she can afford to lose.

SAFE



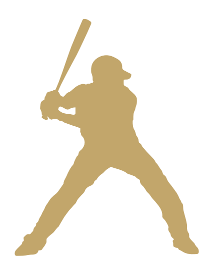
Cash Savings
House
Money Market
CD
Govt. Bonds

GROWTH



Stocks
Corp. Bonds
Mutual Funds
Annuities
TIPs

AMBITIOUS



Real Estate
Emerging Markets
Junk Bonds
IPOs
Venture Capital

"A clear understanding of how a family's wealth is invested increases everyone's conviction to stay the course when an unforeseen event occurs. One of the greatest risks to sustaining wealth is letting emotions drive a change in strategy at the wrong time."[2]

The Wealth Allocation Conversation

The thing is, most investors already have these types of "buckets" where their assets are stowed. The purpose of the allocation strategy is to identify the buckets ahead of time that are best tapped for certain situations. In other words, if today's long-running bull market suddenly experienced a correction, an investor should ask himself how that impacts his current financial situation. For example:

- Does it impact his income and ability to sustain his current lifestyle? If so, how long can he continue paying current expenses before he needs to make a change?
- If it doesn't impact his current lifestyle, what is the potential impact on his long-term goals? How long should he wait before considering a change?
- Does it devastate his more ambitious goals? Will waiting longer help recover any losses? Will accessing those assets quickly solve an immediate problem without sacrificing long-term financial security?

There are two reasons these questions are important. First, if an investor needs cash right away, this stratification of assets can help her determine where to go quickly if cash is needed without compromising long-term goals.

Second, it helps facilitate the conversation among household members to help them arrive at the same conclusion. In other words, if the rental lake house property was placed in the growth assets category, both spouses may agree it is a critical component for their long-term financial goals. However, if the lake house was a "swing to the fences" asset, it may be easier to agree that it's the less crucial asset in an investment portfolio.

Applying the wealth allocation strategy to current assets helps investors rely more on rational reasoning to solve short-term problems with less panic and emotion. The household portfolio is essentially allocated for protection of current lifestyle, growth for future lifestyle and risk-taking for an ambitious lifestyle.

Final Thoughts

By allocating wealth into these three risk groups, it's easier for family members to discuss how to address real-life situations with predetermined solutions. By identifying where the household wealth is invested and the target purpose of each asset, it is easier to stay the course when unforeseen events occur. It also helps to avoid allowing our fears and emotions to drive decisions that could jeopardize long-term financial security.

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[1] Investopedia. "Behavioral Finance." https://www.investopedia.com/terms/b/behavioralfinance.asp. Accessed Dec. 11, 2017.
[2] Lex Zaharoff. Investopedia. April 17, 2017. "A Sensible Approach to Allocating Wealth." https://www.investopedia.com/advisor-network/articles/sensible-approach-allocating-wealth/. Accessed Nov. 29, 2017.