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(Note: Unedited, full version of article follows)

**How Asset Allocation Can Help Smooth Investment Performance**

***By Bob Centrella, CFA***

Wouldn't it be nice if your financial investments had guaranteed returns with low risk? Now that I've got your attention, I'm sorry to say that there is no such animal.  However, I'd like to spend a few minutes talking about a strategy that could help smooth out your investment results over the long term.

Do you toss and turn at night after watching your portfolio value take wild swings every time the stock market jumps up or down? The financial markets today are especially volatile and unpredictable.  Getting double digit returns is no longer a "given" and investors need to be more cautious and diversified in their investments than ever.  Proper asset allocation is crucial to balancing risk and return.  With proper asset allocation (AA), it may be possible to lower the amount of risk in your portfolio while still producing a decent return ... and that should help you sleep better at night!

A portfolio is essentially the sum of different investments.  For example, a simple conservative portfolio might be divided at 50% stocks, 40% bonds and 10% cash.  What does asset allocation (AA) mean and why is it important?  AA is an investment strategy that aims to balance risk and return by allocating the portfolio's assets among different asset types based on one's unique financial circumstances.  There are many different asset types (stocks, bonds, cash, real estate, commodities, international securities, etc) and each has a different expected and historical level of risk and return.  Each asset will behave differently over time,  depending on any number of factors.  By allocating a percentage of your portfolio among different asset types, you create asset diversification which may help reduce risk and smooth out returns.

AA is based on the belief that in different years a different asset category can be the best performing and every asset type will generally have varying levels of risk and return.  Also fundamental to AA is the belief that different asset types do not trade in tandem; hence, diversifying the overall portfolio should reduce overall risk.  For instance, in 2008 when the US stock market was down over 35%, Treasury bonds were up.  A portfolio allocated to both would be down but not nearly as much as the overall stock market.

To summarize, a solid investment strategy can be based on the following principles:

1.  Since the future can't be predicted, we *all* face investment risks, however, these risks can be managed through investment diversification.

2.  Investment diversification is achieved by proper asset allocation among assets that do not move directly in tandem with each other.

3.  Asset allocation requires diversification among different asset types (stocks, bonds, cash, etc) as well as within an asset type (for example, stocks can be domestic and international, large-cap and small-cap, across different industries, etc.)

4.  Risk and returns will vary among asset types over the long-term.  AA should be made based on a belief in long-term results that can produce a satisfactory reward while reducing overall risk.

Remember, AA allows more control over how much return you can possibly get in exchange for assuming a certain level of risk. Proper diversification requires an AA plan, preferably prepared and executed by an experienced professional money manager (**Forza** **Investment Advisory** can prepare a plan for you). Appropriately diversified portfolios can help protect you from severe market fluctuations.

*Bob Centrella, CFA, is President of* ***Forza Investment Advisory, LLC****.   Silex Financial Group newsletter readers can request a free copy of his Weekly Market Update email as well as receive a free, no obligation investment consultation. For more information, go to the "Contact Us" page at* [www.ForzaInvestment.com](http://r20.rs6.net/tn.jsp?llr=sh8mspfab&et=1105462534180&s=193&e=00112nJg_3rk1y63Jfpi8tLG1LUnTiTecH8e6IQxGBLXMZCvQue8YgdNWD1fYavL7O4qyblsFlecfrIT9FU59BS9RPIoTXK0--biS0kt08A2ApSrqK4FwXAGW1MhdLN0Vlc" \t "_blank)*or call us at* ***908-344-9790****.*

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**Unedited, Full Version of Article:**

**THE IMPORTANCE OF ASSET ALLOCATION IN MANAGING AN INVESTMENT PORTFOLIO**

***By Bob Centrella, CFA***

How would you like an investment that is guaranteed to earn above market returns with lower risk involved? Well, now that I’ve got your attention I’m sorry to say that there is no such animal. However, I’d like to spend a few minutes talking about a strategy that could help smooth out your investment results over the long term.

Do you toss and turn at night after watching your portfolio value take wild swings every time the stock market jumps up or down? The financial markets today are especially volatile and unpredictable. Generating double digit returns is no longer a given and investors need to be more diversified in their investments. Proper asset allocation is crucial to balancing risk and return. With proper asset allocation it may be possible to lower the amount of risk in your portfolio while still producing a decent return … and that should help you sleep better at night!

What does Asset Allocation (AA) mean and why is it important? AA is an investment strategy that aims to balance risk and return by allocating a portfolio’s assets among different asset classes according to one’s individual financial goals, risk tolerance and investment time horizon. Each asset class (stocks, bonds, cash, commodities, international, etc) has a different level of risk and return, so each will behave differently over time depending on the macro environment. Since we cannot predict the future, we will always face risks in making investment decisions. One asset class may be down while another may be up in the same timeframe. Although there is no simple formula to find the right AA for every individual, it has been well documented through various industry studies that AA policy is the single most important factor in determining portfolio performance. In other words, your selection of individual securities is secondary to the way you allocate your investments across asset categories. AA allows more control over how much return you can possibly get in exchange for assuming a certain level of risk.

Let’s step back for a second and look at the big picture. Following are the 3 ways to manage money:

1. Market Timing – making an investment decision and moving money among investments by attempting to predict future price movements based on a forecast over a specific time frame.

2. Security Selection – deciding which security to buy or sell compared to others in the same asset class.

3. Asset Allocation – the process of deciding how money gets divided up between different asset classes. AA can be dynamic (market timing) or static and long-term in nature.

Each investment decision utilizes at least one method and more than one method may be used. Long-term or static Asset Allocation is the only method that reduces portfolio risk and is the focus of this article.

A portfolio is essentially the sum of different investments. Building a winning portfolio is based on a number of factors but most important is that it be designed to meet your needs and goals. AA is based on the belief that in different years a different asset class can be the best performing and every asset class will generally have varying levels of risk and return. Also fundamental to AA is the belief that different asset classes are not perfectly correlated, hence diversification can reduce overall risk in terms of variability of returns. The obvious rule of thumb is lower risk = lower return and vice versa. (Risk is defined as standard deviation of return and although I will not go into detail for purposes of this article, one should research the historical standard deviation for various asset classes before making the AA decision.)

To understand the benefits of AA, you must also understand correlations and returns. Correlation is simply defined as the degree to which one asset class moves in tandem with another. Correlations among classes can vary significantly over the long term. Returns may also vary from year to year and asset class to asset class. In general, you build a diversified portfolio by combining asset classes with low or negative correlations. One caveat to keep in mind, correlations are backward looking and there may be periods (such as today) where correlations may be high among asset classes thereby reducing the benefits of asset allocation in the short term.

To summarize, one’s investment strategy can be based on the following building blocks:

1. The future can’t be predicted therefore we all face investment risks. These risks are managed through investment diversification.

2. Investment diversification is achieved by proper asset allocation among assets with low or negative correlation.

3. Asset allocation requires diversification among different asset classes as well as within an asset class.

4. Risk and returns will vary among asset classes over the long-term. Asset allocation should be made based on a belief in long-term results that can produce a satisfactory reward while reducing overall risk.

So remember, asset allocation is a planning tool that allows the investment manager to structure the investment portfolio in a manner most likely to accomplish the goals of each specific individual. An Asset Allocation plan is a long-range, semi-permanent planning decision that has little to do with market timing or hedging – it should not be tinkered with solely because of short-term fluctuations. Properly diversified portfolios can help protect you from severe market fluctuations.