A Guide To Portfolio Construction

by Chris Gallant (Contact Author | Biography)

In today's financial marketplace, a well-maintained portfolio is vital to any investor's success. As an individual investor, you need to know how to determine an asset allocation that best conforms to your personal investment goals and strategies. In other words, your portfolio should meet your future needs for capital and give you peace of mind. Investors can construct portfolios aligned to their goals and investment strategies by following a systematic approach. Here we go over some essential steps for taking such an approach.

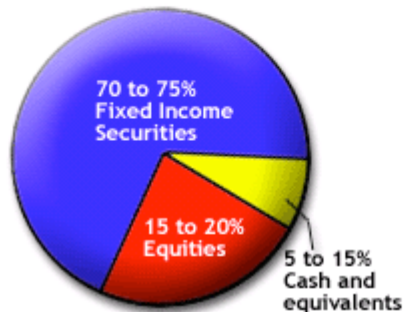
Step 1: Determining the Appropriate Asset Allocation for You
Ascertaining your individual financial situation and investment goals is the first task in constructing a portfolio. Important items to consider are age, how much time you have to grow your investments, as well as amount of capital to invest and future capital needs. A single college graduate just beginning his or her career and a 55-year-old married person expecting to help pay for a child's college education and plans to retire soon will have very different investment strategies.

A second factor to take into account is your personality and risk tolerance. Are you the kind of person who is willing to risk some money for the possibility of greater returns? Everyone would like to reap high returns year after year, but if you are unable to sleep at night when your investments take a short-term drop, chances are the high returns from those kinds of assets are not worth the stress.

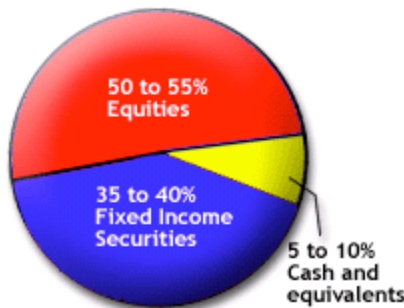
As you can see, clarifying your current situation and your future needs for capital, as well as your risk tolerance, will determine how your investments should be allocated among different asset classes. The possibility of greater returns comes at the expense of greater risk of losses (a principle known as the risk/return tradeoff) - you don't want to eliminate risk so much as optimize it for your unique condition and style. For example, the young person who won't have to depend on his or her investments for income can afford to take greater risks in the quest for high returns. On the other hand, the person nearing retirement needs to focus on protecting his or her assets and drawing income from these assets in a tax-efficient manner.

Conservative Vs. Aggressive Investors
Generally, the more risk you can bear, the more aggressive your portfolio will be, devoting a larger portion to equities and less to bonds and other fixed-income securities. Conversely, the less risk that's appropriate, the more conservative your portfolio will be. Here are two examples: one suitable

for a conservative investor and another for the moderately aggressive investor.



The main goal of a conservative portfolio is to protect its value. The allocation shown above would yield current income from the bonds, and would also provide some long-term capital growth potential from the investment in high-quality equities.



A moderately aggressive portfolio satisfies an average risk tolerance, attracting those willing to accept more risk in their portfolios in order to achieve a balance of capital growth and income.

Step 2: Achieving the Portfolio Designed in Step 1
Once you've determined the right asset allocation, you simply need to divide your capital between the appropriate asset classes. On a basic level, this is not difficult: equities are equities, and bonds are bonds.

But you can further break down the different asset classes into subclasses, which also have different risks and potential returns. For example, an investor might divide the equity portion between different sectors and market caps, and between domestic and foreign stock. The bond portion might be allocated between those that are short term and long term, government versus corporate debt and so forth.

There are several ways you can go about choosing the assets and securities to fulfill your asset allocation strategy (remember to analyze the quality and potential of each investment you buy - not all bonds and stocks are the same):

- *Stock Picking* − Choose stocks that satisfy the level of risk you want to carry in the equity portion of your portfolio − sector, market cap and stock type are factors to consider. Analyze the companies using stock screeners to shortlist potential picks, than carry out more in−depth analyses on each potential purchase to determine its opportunities and risks going forward. This is the most work−intensive means of adding securities to your portfolio, and requires you to regularly monitor price changes in your holdings and stay current on company and industry news. (If you are new to stocks, see *Stock Basics*. For more on developing a strategy for picking stocks, see *Guide to Stock Picking Strategies*.)

- *Bond Picking* − When choosing bonds, there are several factors to consider including the coupon, maturity, the bond type and rating, as well as the general interest rate environment. (For more on these subjects, see *Bond Basics* and *Advanced Bond Analysis*.)

- *Mutual Funds* − Mutual funds are available for a wide range of asset classes and allow you to hold stocks and bonds that are professionally researched and picked by fund managers. Of course, fund managers charge a fee for their services, which will detract from your returns. Index funds present another choice; they tend to have lower fees because they mirror an established index and are thus passively managed. (See *Mutual Fund Basics* and *Index Investing*.)

- *Exchange−Traded Funds (ETFs)* − If you prefer not to invest with mutual funds, ETFs can be a viable alternative. You can basically think of ETFs as mutual funds that trade like stocks. ETFs are similar to mutual funds in that they represent a large basket of stocks − usually grouped by sector, capitalization, country and the like − except that they are not actively managed, but instead track a chosen index or other basket of stocks. Because they are passively managed, ETFs offer cost savings over mutual funds while providing diversification. ETFs also cover a wide range of asset classes and can be a useful tool for rounding out your portfolio. (For more on these, see *Advantages of Exchange−Traded Funds*.)

Step 3: Reassessing Portfolio Weightings

Once you have an established portfolio, you need to analyze and rebalance it periodically because market movements may cause your initial weightings to change. To assess your portfolio's actual asset allocation, quantitatively categorize the investments and determine their values' proportion to the whole. (To learn more, read *Rebalance Your Portfolio To Stay On Track.*)

The other factors that are likely to change over time are your current financial situation, future needs and risk tolerance. If these things change, you may need to adjust your portfolio accordingly. If your risk tolerance has dropped, you may need to reduce the amount of equities held. Or perhaps you're now ready to take on greater risk and your asset allocation requires that a small proportion of your assets be held in riskier small−cap stocks.

Essentially, to rebalance, you need to determine which of your positions are overweighted and underweighted. For example, say you are holding 30% of your current assets in small−cap equities, while your asset allocation suggests you should only have 15% of your assets in that

class. Rebalancing involves determining how much of this position you need to reduce and allocate to other classes.

Step 4: Rebalancing Strategically
Once you have determined which securities you need to reduce and by how much, decide which underweighted securities you will buy with the proceeds from selling the overweighted securities. To choose your securities, use the approaches discussed in Step 2.

When selling assets to rebalance your portfolio, take a moment to consider the tax implications of readjusting your portfolio. Perhaps your investment in growth stocks has appreciated strongly over the past year, but if you were to sell all of your equity positions to rebalance your portfolio, you may incur significant capital gains taxes. In this case, it might be more beneficial to simply not contribute any new funds to that asset class in the future while continuing to contribute to other asset classes. This will reduce your growth stocks' weighting in your portfolio over time without incurring capital gains taxes.

At the same time, always consider the outlook of your securities. If you suspect that those same overweighted growth stocks are ominously ready to fall, you may want to sell in spite of the tax implications. Analyst opinions and research reports can be useful tools to help gauge the outlook for your holdings. And tax-loss selling is a strategy you can apply to reduce tax implications. (For more on achieving your proper asset allocation over time, see *Maintaining Your Mutual Fund Equilibrium*, which offers insight on general rebalancing principles.)

Remember the Importance of Diversification.
Throughout the entire portfolio construction process, it is vital that you remember to maintain your diversification above all else. It is not enough simply to own securities from each asset class; you must also diversify within each class. Ensure that your holdings within a given asset class are spread across an array of subclasses and industry sectors.

As we mentioned, investors can achieve excellent diversification by using mutual funds and ETFs. These investment vehicles allow individual investors to obtain the economies of scale that large fund managers enjoy, which the average person would not be able to produce with a small amount of money.

Summary
Overall, a well-diversified portfolio is your best bet for consistent long-term growth of your investments. It protects your assets from the risks of large declines and structural changes in the economy over time. Monitor the diversification of your portfolio, making adjustments when necessary, and you will greatly increase your chances of long-term financial success.

by Chris Gallant, (Contact Author | Biography)

Chris Gallant is an analyst and contributor for Investopedia. Chris graduated from the University of Alberta School of Business with a major in finance. Prior to joining Investopedia, Chris spent time working with the Alberta Ministry of Finance, taught Business classes at the undergraduate level and helped manage a charitable equity fund for the University of Alberta.

**** This article and more are available at Investopedia.com - Your Source for Investing Education ****