Investing in index funds is smart and it's easy. You don't need to pick stocks or fund managers, just choose well diversified indices and funds with low fees. But you still need to make an important decision. How much are you going to invest in stocks and how much in bonds? And how much of your stock holdings will be international?

In the language of investing, this decision is called asset allocation. Do you like pie? Asset allocation is often illustrated with pie charts. Here, for example, we have a pie allocated to blueberry, raspberry, and key lime. For financial investments, the three main asset classes are equities, that is, stocks, fixed income, including government bonds, municipal bonds, and corporate bonds, and cash.

In finance, cash doesn't refer to dollar bills stuffed under your mattress. Rather, it means money in bank accounts, certificates of deposit, and money market funds. Cash investments don't go up and down as much as stocks or even bonds, but they also don't earn a very high return. As we'll discuss elsewhere in the course, you should have cash in a bank account for emergencies. In this video I'm going to talk about asset allocations recommended by experts. But even experts will disagree as to what's the best allocation for any one person. And, of course, your asset allocation is going to depend upon your own financial goals.

Today, we're going to focus on the biggest financial goal for most people, retirement. Deciding the asset allocation in your retirement account means choosing how much of your retirement savings is invested in different asset classes. For most people, three asset classes-- US equities, international equities, and bonds-- are enough. The appropriate mix of stocks and bonds changes as you get older. Thus, you'll want to review your asset allocation every five years or so.

For those who'd like to keep things simple, there is a simple alternative-- target date funds, also known as life cycle funds or age based funds. These are funds that choose your asset allocation for you and then adjust your allocation as you get older. The target date is the approximate year in which you plan to retire.

Most 401(k) plans offer target date funds as investment alternatives, as do most major mutual fund companies. As you'll read later, target date funds from different companies often have similar asset allocation, but they may charge very different fees. So pay close attention to fees.

Where will the money come from for your retirement? Most likely, your retirement will be supported by a combination of Social Security, maybe a pension, your retirement savings, and your investment in your home. For most Americans, Social Security's going to be the most important source of retirement income. So when making asset allocation decisions in your retirement account, it's important to
remember that your investment in social security is similar to an investment in government bonds. It pays you a predetermined income, indexed to inflation, and guaranteed by the federal government.

Another thing to remember when making asset allocation decisions is that when you are young, most of your savings years are still ahead of you. Thus, your investment portfolio is probably a small fraction of what you will eventually save and you can take more risk in your investments when you're young without adding a lot of total risk to your expected retirement wealth. For example, suppose that you're 25 and you've got $20,000 in your retirement account. And let's say you expect to save at least $10,000 a year for another 45 years. If all of that $20,000 is in stock and you suddenly lost half of it in a market crash, you'd be pretty upset, but it wouldn't make a huge difference in how much money you had when you retired. However, what if you were 65 and you've saved, say, half a million dollars and you planned to retire in five or six years. Now, your lifetime savings is mostly in your portfolio, not in your future. If you lost half of that half a million dollars in a market crash, you might not be able to retire as planned. For this reason, most experts recommend that investors take more investment risk when they're young and less risk as they approach retirement.

Stock funds tend to have higher average returns than bond funds, but they are riskier. Historically, stock funds have experienced infrequent but large losses. Between March 20, 2000 and October 30, 2002, the S&P 500 Index lost almost half its value. And from October 8, 2007 to March 2, 2009, it lost slightly more than half its value. In both cases, the market recovered and hit new highs. However, big losses can be scary and recoveries take time and are not guaranteed. So why not always play it safe? Some people do.

On the course website, there's a link to an interview with Zvi Bodie. He's a professor at Boston University. Zvi invests in low risk, inflation protected US bonds. Currently, such bonds have very low returns but they won't lose value. If you have savings that you're not willing to risk, inflation protected US bonds are as safe an investment as you're going to find. The risk of putting all your investments into bonds when you're young is that your portfolio will grow slowly and you may not end up making investment returns big enough to retire when you want to. In this sense, playing it too safe can also be risky.

So what mix of stocks and bonds do experts recommend? Most financial advisers recommend that you invest more in stocks than bonds when you're young. How much more? Well, the most famous investor of the 20th century, Benjamin Graham, recommended a position of no more than 75% and no less than 25% in either stocks and bonds. And Jack Bogle, who founded both Vanguard and the first indexed mutual fund, recommends that the percentage of your portfolio invested in the bonds be roughly equal to your age and the percentage in stocks roughly 100 minus your age. So, if you were 40 years old, you would hold 60% of your portfolio in stocks and 40% in bonds. And in her book, Making the Most of Your Money Now, personal finance writer Jane Bryant Quinn suggests owning a percentage of stocks equal to 110 minus your age and the rest in bonds. So if you were 40, you'd hold 70% of your portfolio in stocks and 30% in bonds.

What about other asset classes such as commodities, gold, real estate, and cash? As I discussed in another video, commodities in gold aren't appropriate investments for most people. They certainly shouldn't play a major role in a retirement portfolio. If you own your home, you already have a large investment in real estate. Plus, equity index funds give you an indirect investment in the real estate owned by the companies in the index. I'm not discussing real estate rental properties, real estate partnerships, or other small businesses in this course. And such investments aren't usually held in retirement accounts.
Finally, there is cash. As discussed elsewhere in the course, it's a very good idea to have an emergency fund of cash in a savings account or money market fund. Your emergency cash should not, however, be held in a retirement account, such as a traditional IRA or a 401(k) account.