

Asset Allocation: Building a Portfolio for Your Financial Goals

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Demystify asset allocation with this comprehensive guide. Learn how to align your portfolio with your financial goals, assess your cash flow needs and build a resilient investment strategy for any market.

By Dan Kern

Asset allocation is the process of determining how much a portfolio invests in stocks, bonds and cash. Each asset class has a different return and risk profile, so determining the appropriate combination is an important aspect of portfolio design. Also, asset allocation is an ongoing process and should be periodically reviewed. Although the appropriate blend of stocks, bonds and cash may change over time, it is important to avoid the temptation to change targets in response to moves in the market. The right time to modify asset allocation is when there has been a change in personal circumstances, such as the investor's goals, time horizon, cash needs, income or obligations.

Asset allocation targets are created through an assessment of the following four considerations:

1. Investment goals and time horizons are quantifiable elements that define the amount of savings needed and the target date to achieve a particular goal. Some goals, such as saving for a down payment on a house, require a lump sum needed at a future date. Other goals, such as saving for retirement or education, involve building savings that will be spent in increments in the future.

Investors with multiple goals may want to consider setting a distinct asset allocation target for each goal. Saving for goals that are far in the future may necessitate a different approach than saving for a near-term goal. For example, an investor saving for retirement in 30 years can withstand considerable stock market volatility; an investor saving to buy a house in three years may require a less volatile portfolio tilted toward short-term, high-quality bonds and money funds.

2. Cash flow needs are identified when reviewing a budget. This can include known

expenses as well as an estimate of what might be needed to cover emergencies such as home repairs, medical expenses, and other unplanned needs. Establishing a liquidity reserve of less-volatile fixed-income holdings to cover projected and emergency cash needs can reduce the likelihood of being forced to sell stocks at an inopportune time.

3. Risk capacity and risk tolerance are interrelated elements in the asset allocation process.

Risk capacity is the amount of risk an investor can withstand while remaining financially stable. Investors with abundant savings, low debt and stable income may have the capacity to take on more risk in the investment portfolio. Risk capacity, however, is only part of the risk equation.

Risk tolerance, the willingness to lose some or all of an investment in exchange for potentially higher returns, is equally important. Some investors have the capacity to take substantial risk but not the willingness to take on a lot of risk. Likewise, some investors may be risk seekers but do not have the savings or cash flow necessary to meet their financial obligations in a down market. Consequently, it is important to think about both risk capacity and tolerance when developing asset allocation targets.

4. Other considerations may influence the asset allocation process. For example, investors with stable sources of income may be able to take more portfolio risk than investors whose compensation fluctuates unpredictably from year to year. Expected inheritances, gifts, or sales of other assets may also be factors influencing the asset allocation strategy.

Investment goals and time horizons are starting points in identifying the target return necessary to reach the investor's goals, with cash needs and risk considerations as important additional factors in establishing allocations to stocks, bonds and cash. In general, investors with long-term time horizons, low near-term cash needs, and moderate-to high-risk capacity and tolerance will have an asset allocation that emphasizes equity investments. The shorter the time horizon and greater the near-term cash needs, the greater the need for more liquid and stable fixed-income investments.

Aligning portfolio return expectations with goals and time horizons is an important final step in the asset allocation process. This step may identify projected shortfalls between the proposed asset allocation and the desired goal, which can be a sign that something in the plan needs to be modified. This can be the portfolio strategy, savings target or goal. There may also be circumstances in which the investor can achieve a goal by taking less risk or modifying the goal to be more ambitious in size or timing. Based on all these factors, it is clear that asset allocation is innately personal. An investment management professional who has a clear understanding of an investor's goals, time horizon, cash

needs and other factors can serve as a good sounding board when determining an ideal asset allocation.

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