For many years, Foster Group has approached asset allocation using an analysis we call our Lifeboat Drill. Setting a proper mix of growth assets like stocks or real estate, and preservation assets like bonds, begins with understanding our clients’ future cash flow needs. The answers to two questions provide the foundation for our Lifeboat Drill.

First, we explore the minimum return rate you must earn on your portfolio assets to meet all of your anticipated future cash flow needs. Quantifying this return allows us to determine the minimum amount of growth assets you will need.

Next, we focus on the minimum amount of preservation assets you need. Growth assets are wonderful tools for generating long-term returns, but to capture these returns, investors must be able to remain invested through some difficult market downturns. Preservation assets like bonds help buffer these shorter-term gyrations. We use preservation assets to build a Lifeboat “liquidity cushion” for our clients, to ensure they are not forced to sell growth assets during depressed markets. The Lifeboat is measured in terms of the number of years of liquidity cushion we desire.

Historically, an eight-year Lifeboat cushion has proven enough to weather all but the very worst stock market correction in US history (the Great Depression). So, we might decide to build a Lifeboat of preservation assets equal to the next eight years of anticipated cash flow needs. If stock and/or real estate markets decline, we should have eight years of liquidity to access while we wait for a recovery.

Setting the minimum amounts of growth and preservation assets helps define a reasonable range of investment mixes that offer our clients a high probability of successfully reaching their financial goals. Additionally, we have found the Lifeboat Drill often leads to remarkable conversations beyond asset allocation, as we focus more on our clients’ hopes, goals, and dreams.