EDUCATORS RETIREMENT PLAYBOOK

Educators Retirement Playbook
http://www.educatorsretirementplaybook.com

Back to Basics: Diversification and Asset Allocation

Why is diversification so important? The simple reason is that it helps manage the risk of loss in your portfolio.

When investing, particularly for long-term goals, there are two concepts you will likely hear about over and over again — diversification and asset allocation. Diversification helps limit exposure to loss in any one investment or one type of investment, while asset allocation provides a blueprint to help guide your investment decisions. Understanding how the two work can help you put together a portfolio that targets your specific needs.

Diversification: Spreading out risk

Diversification refers to the process of investing in a number of different securities to help manage risk. The theory is that if some investments in your portfolio decline in value, others may rise or hold steady.

For example, say you wanted to invest in stocks. Rather than investing in just domestic stocks, you could diversify your portfolio by investing in foreign stocks as well. Or you could choose to include the stocks of different size companies (small-cap, mid-cap, and/or large-cap stocks).

If your primary objective is to invest in bonds for income, you could choose both government and corporate bonds to potentially take advantage of their different risk/return profiles. You might also choose bonds of different maturities, because long-term bonds tend to react more dramatically to changes in interest rates than short-term bonds. As interest rates rise, bond prices typically fall.

Asset allocation: Investing strategically

Asset allocation is a strategic approach to diversifying your portfolio among different asset classes that seeks to pursue the highest potential return within a certain level of risk. After carefully considering your investment goals, time horizon, and risk tolerance, you would then invest different percentages of your portfolio in targeted asset classes to pursue your goals. A careful analysis of these three personal factors can help you make strategic choices that are suitable for your needs.

Generally speaking, a large accumulation goal, a high tolerance for risk, and a long time horizon would typically translate into a more aggressive strategy and therefore a higher allocation to stock/growth investments. One example of an aggressive strategy is 70% stocks, 20% bonds, and 10% cash.

The opposite is also true: A small accumulation goal (or one geared more toward generating income), a low tolerance for risk, and a shorter time horizon might require a more conservative approach. An example of a more conservative, income-oriented strategy is 50% bonds, 30% stocks, and 20% cash.

Rebalance to stay on target

Over time, an asset allocation can shift simply due to changing market performance. For example, in years when the stock market performs particularly well, a portfolio may become overweighted in stocks. Or in years when bonds outperform, they may end up comprising a larger-than-desired percentage of the portfolio. In these situations, a little rebalancing may be in order.

There are two ways to rebalance. The first is by simply selling securities in the overweighted asset class and directing the proceeds into the underweighted ones. The second method is by directing new investments into the underweighted asset class until the desired allocation is achieved.

Keep in mind that selling securities can result in a taxable event, unless they are held in a tax-advantaged account, such as an employer-sponsored retirement plan or an IRA.

Diversification and asset allocation are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss.

"Winning" asset classes over time

The following table shows how many times during the past 30 years each asset class has come out on top in terms of performance. It helps illustrate why diversifying among asset classes can be important. Bear in mind, however, that this table does not reveal the ups and downs experienced along the way. Although stocks in general, and foreign stocks in particular, have come out on top in terms of winning years, the amount of volatility they experience is typically greater, and sometimes far greater, than that of cash and bonds.

Asset class	Number of winning years, 1989-2018
Cash	4
Bonds	5
Stocks	10
Foreign stocks	11

Source: Thomson Reuters, 2018. Performance is from December 31, 1989, to December 31, 2018. Cash is represented by Citigroup 3-month Treasury Bill Index. Bonds are represented by the Citigroup Corporate Bond Index, an unmanaged index. Stocks are represented by the S&P 500 Composite Price Index, an unmanaged index. Foreign stocks are represented by the MSCI EAFE Price Index, an unmanaged index. Investors cannot invest directly in any index. However, these indexes are accurate reflections of the performance of the individual asset classes shown. Returns reflect past performance and should not be considered indicative of future results. The returns do not reflect taxes, fees, brokerage commissions, or other expenses typically associated with investing.

The principal value of cash alternatives may fluctuate with market conditions. Cash alternatives are subject to liquidity and credit risks. It is possible to lose money with this type of investment.

The principal value of bonds may fluctuate with market conditions. Bonds are subject to inflation, interest rate, and credit risks. Bonds redeemed prior to maturity may be worth more or less than their original cost. U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest, whereas corporate bonds are not.

The return and principal value of stocks may fluctuate with market conditions. Shares, when sold, may be worth more or less than their original cost.

The risks associated with investing on a worldwide basis include differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country.

Investments offering the potential for higher rates of return also involve higher risk.

Investing in mutual funds

Because mutual funds invest in a mix of securities chosen by a fund manager to pursue the fund's stated objective, they can offer a certain level of "built-in" diversification. For this reason, mutual funds may be an appropriate choice for novice investors or those wishing to take more of a hands-off approach to their portfolios. Including a variety of mutual funds with different objectives and securities in your portfolio will help diversify your holdings that much more. You can also select a combination of mutual funds to achieve your portfolio's targeted asset allocation.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.