



SBA Special Report

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Asset Allocation

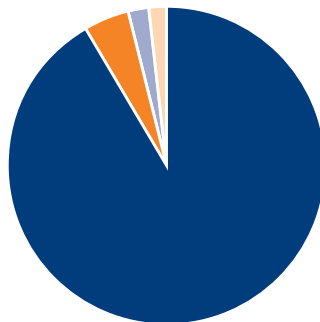
Balancing risk and reward with class

Life is full of risks and rewards. With investing, the reward for taking on risk is the potential to make more money. Of course, you can also lose more money. The key is finding a balance between your risk tolerance and reward potential. Asset allocation can help.

A powerful decision

The most significant decision you'll make when building an investment portfolio is determining your asset allocation.¹ How you divide your investments among different asset classes can be more important than the actual investment choices you make. Finding the right balance between higher and lower risk investments is the key to managing risk in a portfolio. That's the power of asset allocation.

Portfolio performance is determined by:



- Asset Allocation – 91.5%
- Individual Investment Selection – 4.6%
- Other – 2.1%
- Market Timing – 1.8%

A portfolio with class

Asset allocation involves choosing a portfolio by selecting combinations of investments to meet the specific needs and goals of an individual investor. This is done by dividing the portfolio among different asset classes. The three main asset classes that make up a typical portfolio include:

Stocks (equity)

Stocks represent equity or ownership in a corporation. If you own stock in a company, you own a piece of that company. Stocks have historically produced the highest returns; however, they also carry the most risk, with a tendency towards greater price swings – highs and lows – that makes them more volatile than either bonds or money market instruments.

Bonds (income)

Bonds are basically loans in which the borrower agrees to pay back principal, plus interest (income), by a certain time. The borrower's ability to repay typically impacts the bond's rate. Bonds are closely tied to changes in interest rates – i.e., when rates fall, bond prices rise – and are considered less risky than stocks in general.

¹ A landmark study, "Determinants of Portfolio Performance," by Brinson, Hood and Beebower, presented in Financial Analysts Journal (May – June, 1992), and its update in 1996, showed that asset allocation decisions, far more than any other factor, affected the long-term performance of an investment portfolio.

* "Determinants of Portfolio Performance II: An Update." Brinson, Singer and Beebower, 1996.



Money Market (cash)

Money market instruments are investments in short-term debt securities (such as CDs) and government securities (such as Treasury Bills). Like bonds, money market instruments are also tied to changes in interest rates; however, where bond prices tend to move in the opposite direction from interest rates, money market instruments tend to track interest rates.

Historically, market conditions that cause one asset category to do well often cause another category to have average or poor returns. That's why a portfolio that invests in more than one asset category helps reduce the overall risk of losing money.

Asset Allocation vs. Diversification

Asset allocation is often confused with diversification, which can be summed up as "not putting all your eggs in one basket." While both help to manage risk, asset allocation takes the concept a step further. Asset allocation involves dividing a portfolio *among and within* different asset classes (such as stocks, bonds and money market instruments). Diversification involves only spreading your dollars among a variety of investments, but doesn't necessarily have to involve different asset classes.

A balancing act – time and tolerance

The process of asset allocation is a personal one and varies by investor. If you don't include enough risk in your portfolio, your investments may not earn enough money to meet your long-term financial goals. If you include too much risk, however, your money may not be there when you need it. The key is finding the right balance between risk and reward that works within your *time horizon* and *risk tolerance*.

- **Time horizon** – The expected time to achieve a particular financial goal. Investors with longer time horizons, such as retirement, may feel more comfortable taking on riskier investments as they can wait out the inevitable ups and downs of the market; while those with shorter time horizons, such as saving for college, would likely take on less risk.
- **Risk tolerance** – An investor's ability and willingness to lose some or all of his or her original investment in exchange for greater potential returns. An investor with high-risk tolerance is more likely to risk losing money to get better results; while someone with low-risk tolerance tends to favor investments that will preserve the original investment.

Professional modeling

To put asset allocation strategies to work for you, consider seeking help from a professional. Financial planners and asset allocation strategists use computer modeling techniques to analyze the risk and return characteristics of asset classes and then construct model portfolios. Questionnaires based on your total financial situation, risk tolerance and goals can also help professionals build a portfolio with the right asset allocation for you.

Of course, using asset allocation as part of your investment strategy neither assures nor guarantees better performance and cannot protect against loss in declining markets.

KEEP LEARNING

SBA's Special Report on Diversification provides additional information on the concept of asset allocation. In addition, your SBA representative can help you understand how to use asset allocation strategies to build a portfolio that best meets your financial goals.

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