



SBA Special Report

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Diversification

Managing risk with common sense

Your approach to investing for your future should be no different from the way you approach other important decisions in your life: Use common sense and don't put all your eggs in one basket. This best sums up the concept of diversification.

The fine print is right

Read the fine print on most investment-related materials and one thing is clear: all investing involves some degree of risk. Diversification is a simple way to manage those risks. It's a concept that involves spreading your dollars among a variety of investments; or, as the popular phrase says, not putting all your eggs in one basket.

By taking such an approach, you could be less affected by losses in any one investment; while any losses you do incur may be offset by gains in another investment. Of course, as the fine print says, this approach doesn't guarantee better performance or protect against loss in declining markets.

A class performance

An investment portfolio consists of any of three main asset classes: stocks, bonds and money market instruments (cash). The key to a diversified portfolio is to identify investments in segments of each asset category that may perform differently under different market conditions.

An example:

Rain or shine, you're covered

You invest in the stock of two companies – one manufactures raincoats, the other makes sunglasses. A rainy month brings great profits for the raincoat company, but profits slide during sunny months. So, you'd want to manage those highs and lows by investing in something that reacts differently to the same condition, the weather: sunglasses.

As this simplified example shows, a diversified portfolio can be made up entirely of investments in one asset class; in this case, that asset class is stocks.

Diversifying through asset allocation

Historically, market conditions that cause one asset category to do well often cause another category to have average or poor returns. Consider the following scenario:

You win some, you lose some

You have a portfolio that is equally invested in bonds and money market instruments. As interest rates rise, the value of the bonds in your portfolio drops accordingly, and your portfolio "loses" money. Your loss, however, is offset by an increase in value on your money market investments, as these two types of investments react differently to the same external forces – the change in interest rates.



This example is based on the principle of “asset allocation,” which takes diversification a step further by spreading investments among and within different asset categories. Many investors use asset allocation to diversify their investments; however, a diversified portfolio doesn’t necessarily need to be divided among different asset classes (as described in the “rain or shine” example).

For a more detailed explanation of this concept, see SBA’s Special Report on Asset Allocation.

Spreading your eggs among different baskets

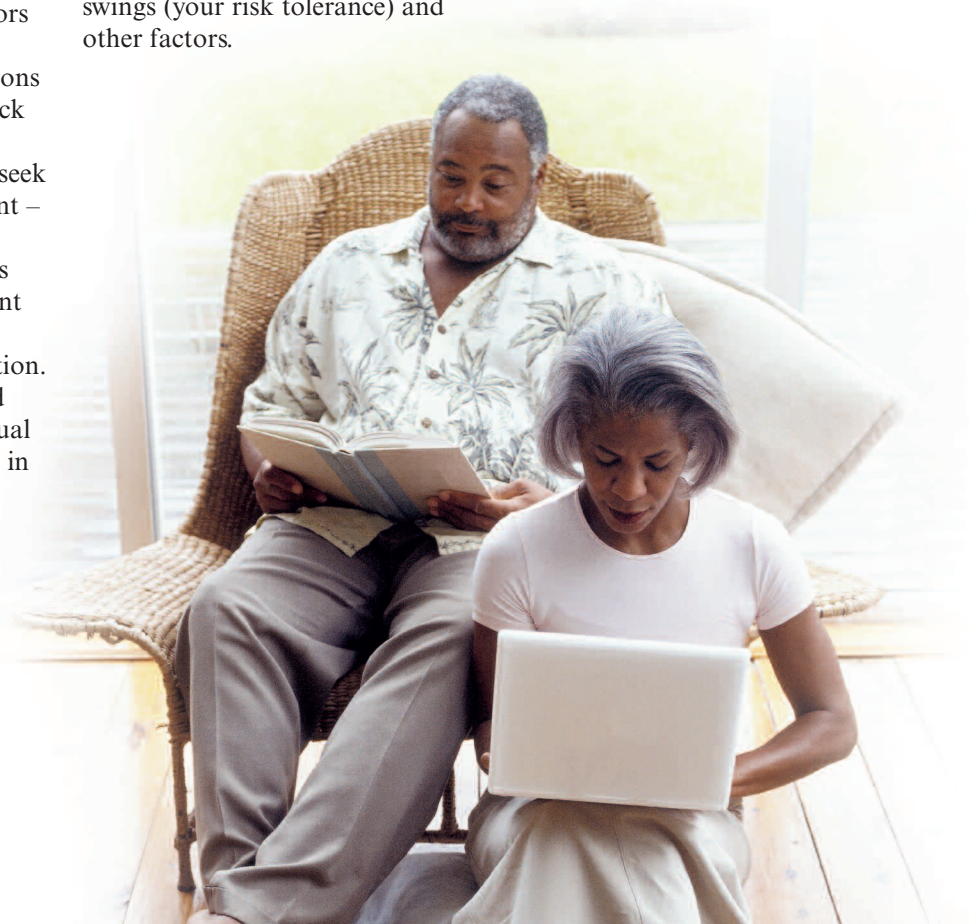
No one expects individual investors like you to predict fluctuating interest rates or study the operations of each company and predict stock prices. Your best bet to put diversification into practice is to seek full-time professional management – the kind you get by investing in mutual funds and the investments you’ll likely find in your retirement plan. These investment vehicles automatically provide diversification. All you need to do is make broad decisions about the types of mutual funds, securities and asset classes in which to invest.

For example, you can choose to divide your investment among a “global/ international” fund, a “large cap value” option and a “small/ mid/specialty” fund. This would ensure you’re diversified across different kinds of asset classes with different investment objectives – all of which will react differently to different market circumstances. In essence, your eggs will be spread among different baskets.

Note that how much money you choose to invest in each fund and asset class will depend on your own investment objectives, including how long you have until you’ll need your money, how well you react to market swings (your risk tolerance) and other factors.

KEEP LEARNING

SBA’s Special Report on Asset Allocation can help you learn more about these and other important investing concepts.



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