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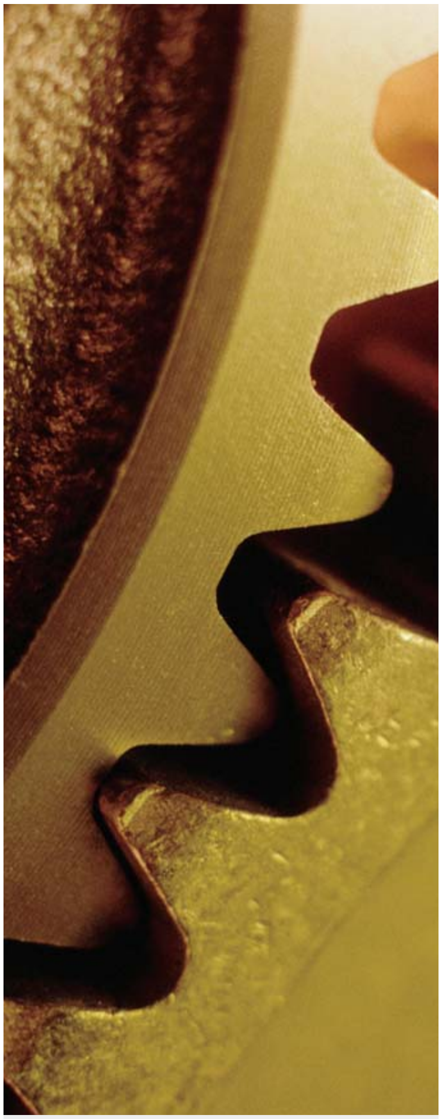
The Nuts and Bolts of Asset Allocation



Building a Strong Retirement Portfolio

Just as certain structures depend on nuts and bolts for their strength and stability, you might say that your retirement portfolio relies on asset allocation for its strength and stability. In past issues of this newsletter, we've discussed the concept of asset allocation, and now is a good time to revisit it, how it works and what it really means for you and your retirement savings. To help reinforce and enrich your understanding of a very important part of retirement investing, let's take a closer look at the nuts and bolts of asset allocation.

What is asset allocation?

Asset allocation is a process designed to keep your investment risk within your comfort zone while maintaining a reasonable rate of return on your retirement savings. You do this by strategically allocating your money among the different asset classes—stocks, bonds and cash alternatives or stable value investments—and spreading your investments among the various categories *within* each asset class. In doing so, you can take advantage of the inherent risk/return properties of each asset class through a customized investment mix designed to help you pursue your individual goals within your risk profile.

How does asset allocation work?

Asset allocation works on the principle that investments in various asset classes will react differently to changing market conditions. For example, while one investment may decline due to market fluctuation, another may simultaneously increase in value and offset the decline.

In determining how to allocate your retirement savings, you should consider several factors:

Goals. What do you envision for your retirement—travel, leisure, starting a new business, working part-time? As a rule of thumb, many experts agree you may need about 75 percent of your pre-retirement income to maintain your current standard of living.

Time horizon. The timeframe you have to invest will determine the level of risk you may be willing to take. If you have a long time until retirement, you may be willing to invest more assets in stocks and ride out periods of market downturns and volatility in hopes of achieving a higher long-term return. On the other hand, if your retirement date is approaching, you may want to help protect your nest egg by allocating more money to bonds and cash alternatives—or stable value investments, which typically do not fluctuate as much as stocks.

Risk tolerance. Do you panic when the market dips? Perhaps you'd be more comfortable accepting potentially lower, though steadier, returns through a more conservative investment mix. Or maybe you're willing to assume greater risks—and possible losses—for higher potential returns.

Speaking of risk, you should be aware that it can take various forms:

Volatility risk. This is the risk that the value of the investments in your retirement account may fluctuate over time and you may lose money.

Inflation risk. This is the risk that you may not earn enough of a return on your investments to cover inflation, so the purchasing power of your savings may decrease.

Credit risk. Associated with bonds, credit risk means that the company issuing the bond may be unable to make interest or principal payments.

Interest rate risk. This refers to the fact that the value of fixed income investments (bonds) may go up or down when interest rates fluctuate. For example, when interest rates rise, the value of a bond will decline, and vice versa.

Each asset class has different risks and tends to perform differently during various market cycles.

Stocks and stock funds, historically, have shown greater long-term growth potential than other types of investments, but have also experienced the highest volatility risk.

Bonds and bond funds have less volatility risk and growth potential than stocks but, historically, may be subject to credit and interest rate risk.

Stable value investments are agreements issued by various insurance companies, banks or other financial institutions and commonly referred to as "guaranteed investment contracts" and "bank investment contracts"—together called "GICs." The "guarantee" in a GIC fund refers to the guarantee by the issuers of specific rates of return for stated periods of time. These investments tend to remain stable in varying market conditions, but offer limited appreciation potential.

Cash alternatives: Money market funds, Treasury bills, CDs, etc., which have the least volatility risk and the highest inflation risk, also offer the lowest appreciation potential.*

Why is asset allocation so important to your retirement savings?

How you allocate your investments may be a huge factor in how your retirement portfolio performs. If you invest a large portion of your retirement savings in, for example, highly volatile technology stocks, you would have the potential to earn significant returns—or, perhaps just as easily, suffer substantial losses. But are you willing to take that risk? Conversely, if you invest your entire retirement savings in low-risk, low-return money market funds, you can generally expect to protect your principal.* However, it's highly unlikely that you would stay ahead of inflation, and you may even end up watching the real value of your savings shrink in the long run. An appropriate asset allocation strategy can help you accomplish two important goals:

- It can help you ride out the ups and downs of the market by strategically diversifying your investments while pursuing a more consistent return on your money, and
- It lets you adjust your exposure to risk, based on your personal risk profile.

Just as nuts and bolts need to be occasionally tightened and adjusted, your asset allocation should be re-evaluated and readjusted periodically. Your personal circumstances may have changed, which may alter your future financial needs. Also, certain portions of your retirement portfolio may have performed better than others since the original allocation. As a result, the asset allocation percentages of stocks, bonds and cash equivalents or stable value investments that you originally chose may not be reflected in your current asset allocation.

You may want to consult a Financial Advisor to help you review your retirement portfolio's asset allocation and evaluate whether the "nuts and bolts" need to be adjusted. If you need an asset allocation questionnaire, you can contact your local Human Resources representative.

*Shares of money market funds are neither insured nor guaranteed by the U.S. government and are sold only by prospectus. Past performance is no guarantee of future results. There can be no assurance that a fund will be able to maintain a stable net asset value of $1.00 per share.

Asset allocation does not assure a profit or protect against a loss in declining markets.

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