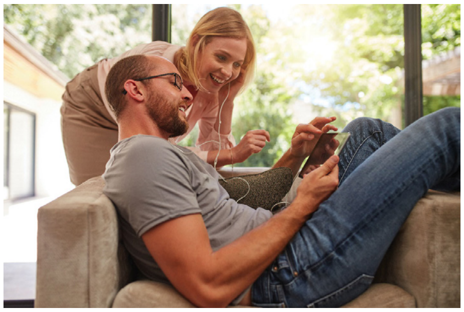
SPECIAL REPORT

# Diversification

## Managing risk with common sense



A participant's approach to investing for the future in PSERS Defined Contribution (DC) Plan investment options can be similar to the approach used for other life decisions: Use common sense, and, as the saying goes, "Don't put all your eggs in one basket." This sums up the concept of diversification.

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## The fine print has a point

The fine print on investment-related materials often states that all investing involves some degree of risk. Diversification is one way to manage those risks. It's a concept that involves spreading investment dollars among a variety of options.

By taking such an approach, a participant could be less affected by losses in any one investment; while any losses that are incurred 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.

## Understanding performance

An investment portfolio often consists of a combination of the three main asset classes - stocks, bonds, and money market instruments. Diversifying a portfolio involves identifying investments in segments of each asset category that may perform differently under different market conditions.

**A "rain or shine" example**

Let's say hypothetically that an individual invests 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, the investor could help 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, both investments are 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:

**Win some, lose some**

A participant has a portfolio that is equally invested in bonds and a short-term investment like a money market. As interest rates rise, the value of the bonds in the portfolio drops accordingly, and the portfolio "loses" money. The participant's loss, however, is offset by an increase in value on the 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 participants 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 the Special Report on Asset Allocation.

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## Asset allocation through target date investments

An alternative to asset allocation among the available investment options is to invest in a target date investment based on your estimated normal retirement age. Target date investments are professionally managed and periodically adjust with a specific target retirement date in mind. Professional investment managers invest your money in a mix of funds across a variety of asset classes to create a diversified investment portfolio, guided by the number of years until retirement. This gives a participant the ability to diversify within a single investment option.

## Spreading your eggs among different baskets

No one expects participants to predict fluctuating interest rates or study the operations of each company and predict stock prices. Some people seek guidance from a financial professional to review the investment option choices that are available in an employer-sponsored plan like your PSERS Defined Contribution Plan.

## 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 only involves distributing the assets among a variety of investments, but doesn’t necessarily have to involve different asset classes.

**For PSERS members in Class T-G, Class T-H, and Class DC, you can view your PSERS DC Plan online through PSERS MSS Portal. Go to your PSERS DC Plan account, then visit the *Investments* section to learn more about the investment options available in the PSERS DC Plan and their historical performance.**

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