SPECIAL REPORT

Asset allocation

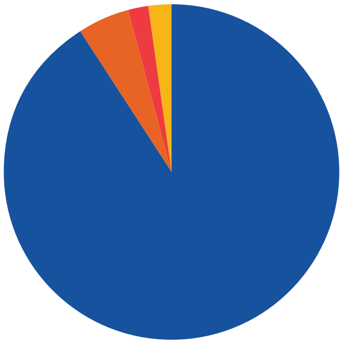
Balancing risk and reward with "class"

Life is full of risks and rewards. For any kind of defined contribution (DC) plan participant, the reward for taking on risk is the potential to make more money. Of course, the participant can also lose more money. The key is finding a balance between the participant's risk tolerance and reward potential. Asset allocation can help.

A powerful decision

The most significant decision a participant will make when building an investment portfolio is determining the asset allocation.[1] How a participant divides investments among different asset classes can be more important than the actual investment choices made. 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%

* "Determinants of Portfolio Performance II: An Update."

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.

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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 participant. 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 someone owns stock in a company, they 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.

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.

A balancing act – time and tolerance

The process of asset allocation is a personal one and varies by the participant. If there isn't enough risk in the portfolio, the investments may not earn enough money to meet the participant's long-term financial goals. If too much risk is included, however, the invested money may not be there when the participant needs it. The key is finding the right balance between risk and reward that works within the participant's unique time horizon and risk tolerance.

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

Professional guidance

If you want to put asset allocation strategies to work for you, you may wish to consider seeking help from a professional. Financial planners help analyze the risk and return characteristics of asset classes and ask questions about your total financial situation, risk tolerance, and goals to help build the right asset allocation for you.

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

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.

With PSERS, you're on your way!

For PSERS members in Class T-G, Class T-H, and Class DC, you can review and change your asset allocation in the PSERS DC Plan online through PSERS MSS Portal. Go to your PSERS DC Plan account, then click *Account* > *Manage Investments* to reallocate how your current and future contributions are invested.

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