

## Baird Investor Education

# Asset Allocation: A Sound Investment Strategy

In today's complex financial markets, you have an impressive array of investment vehicles from which to select. Each investment also carries some risks, making it important to choose wisely if you are selecting just one.

The good news is that there's no rule that says you must stick with only one type of investment. In fact, you can potentially lower your investment risk and increase your chances of meeting your investment goals by practicing "asset allocation."

### What Is Asset Allocation?

Asset allocation refers to the way in which you weight diverse investments in your portfolio in order to try to meet a specific objective. For instance, if your goal is to pursue growth (and you're willing to take on market risk in order to do so), you may decide to place 20% of your assets in bonds and 80% in stocks.

The asset classes you choose, and how you weight your investment in each, will probably hinge on your investment time frame and how that matches with the risks and rewards of each asset class.

### Stocks, Bonds, and Money Markets

Here's a closer look at the risk and reward levels of the major asset classes:

- **Stocks** — Well-known for fluctuating frequently in value, stocks carry a high level of market risk (the risk that your investments' value will decrease after you purchase them) over the short term. However, stocks have historically earned higher returns than other asset classes by a wide margin, although past performance is no predictor of future results. Stocks have also outpaced inflation — the rising prices of goods and services — at the highest rate through the years, and therefore carry very low inflation risk.

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## Points to Remember

1. Asset allocation is the way in which you spread your investment portfolio among different asset classes, such as stocks and stock mutual funds, bonds, and bond mutual funds.
2. When prices of different types of assets do not move in tandem, combining these investments in a portfolio can help reduce the variability of returns, commonly referred to as "market risk."
3. Mutual funds are pools of securities, usually offering diversification within a single asset class. Some mutual funds may include several asset classes.
4. The asset allocation that is right for you depends on your investment time frame, goals, and tolerance for risk.
5. As your investment time frame and goals change, so might your asset allocation. Many financial experts suggest reevaluating your asset allocation periodically or whenever you experience a milestone event in your life such as marriage, the birth of a child, or retirement.

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- **Bonds** — In general, these securities have less severe short-term price fluctuations than stocks, and therefore offer lower market risk. On the other hand, their overall inflation risk tends to be higher than that of stocks, as their long-term return potential is also lower. Bond returns may be influenced by movements in short-term interest rates. When interest rates rise, bond prices are likely to fall.

- **Money market instruments**<sup>1</sup> — Among the most stable of all asset classes in terms of returns, money market instruments carry very low market risk. At the same time, these securities don't have the potential to outpace inflation by as wide a margin through the years as stocks. Investment in a money market fund is neither insured nor guaranteed by the U.S. government, and there can be no guarantee that the fund will maintain a stable \$1 share price. The fund's yield will vary.

### Diversification: The Foundation of Asset Allocation

Before exploring just how you can put an asset allocation strategy to work to help you meet your investment goals, you should first understand how diversification — the process of helping reduce risk by investing in several different types of individual funds or securities — works hand in hand with asset allocation.

When you diversify your investments among more than one security, you help reduce what is known as "single-security risk," or the risk that your investment will fluctuate widely in value with the price of one holding. Diversifying among several asset classes increases the chance that, if and when the return of one investment is falling, the return of another in your portfolio may be rising (though there are no guarantees). Neither asset allocation nor diversification guarantee against investment loss.

For example, in 2002, large-company stocks lost 22.1%, while long-term government bonds returned 13.8%.<sup>2</sup> (Keep in mind that past performance cannot guarantee future results.)

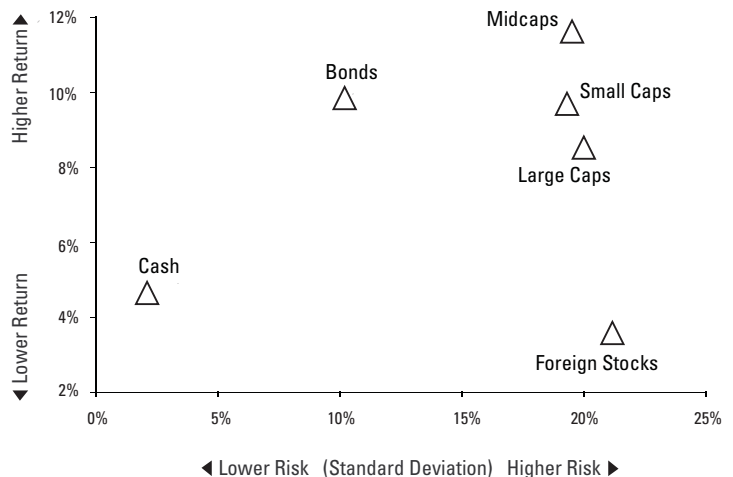
### Asset Allocation Can Work

The chart on the next page can help you select an appropriate allocation for your investment portfolio based on your life stage. For instance, at age 25 you may decide to invest with the goal of retiring in comfort within 40 years. Most likely, your investment goal is to achieve as much growth as possible — growth that will outpace inflation substantially. In aiming to reach this goal, you may allocate 70% of your assets into aggressive growth stocks, 20% into bonds, and 10% into money market instruments. You have years to ride out the wide fluctuations that come with stocks, but at the same time, you potentially lower your risk with your bond and money market holdings.

Because your goals and circumstances are unique, you may want to talk with an investment advisor who can help you tailor an allocation strategy for your needs. Generally, your asset allocation will change as you reach different stages in your life, as your investment goals also change along with these shifts in lifestyle.

### Risk Reward Map (1980-2007)

Different investments offer different levels of potential return and market risk. Unlike stocks and corporate bonds, government T-bills are guaranteed as to principal and interest, although money market funds that invest in them are not. Past performance is not indicative of future results.



Sources: Standard & Poor's; Center for Research and Security Prices; Morgan Stanley; the Federal Reserve. Large caps are represented by the annual total returns of the S&P 500; midcaps by the annual total returns of the composite of CRSP 4th-5th decile portfolios and the S&P MidCap 400 Index; small caps by the total returns of the composite of CRSP 6th-8th decile portfolios and the S&P SmallCap 600 index; foreign stocks by the annual total returns of the MSCI EAFE Index; bonds by the annual total returns of long-term Treasuries (10+ years maturity); and cash by the annual total returns of 3-month T-bills. Investors cannot directly purchase an index. (CS000136)

If you have been investing aggressively for retirement for more than 20 years and are now less than 10 years from retiring, protecting what your investment may have earned from market ups and downs may become more important. In this case you may want to gradually shift some of your stock allocation into your bond and money market holdings. Keep in mind, however, that many financial experts recommend that stocks be considered for every portfolio to maintain growth potential.

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### A Simple Process, Some Dramatic Potential Results

Asset allocation is a simple concept, yet vital to long-term investment success. In fact, a landmark study cited in Financial Analysts Journal shows that about 90% of the variability of average total returns earned by balanced mutual funds and pension plans over time was the result of asset allocation policy.<sup>3</sup> For many individual investors, the asset allocation decision amounts to choosing what types of mutual funds to invest in and the amount to invest in each type of fund. Others may want to add individual securities to this mix after exploring their investment options.

Regardless of the asset allocation strategy you choose and the investments you select, keep in mind that a well-crafted plan of action over the long term can help you weather all sorts of changing market conditions as you aim to meet your investment goal(s).

### Sample Asset Allocations\*

	Risk Level					
	Low		Moderate		Aggressive	
% Treasury Bills	30	30	20	10	0	10
% Bonds	40	30	30	40	30	20
% Growth Stocks	30	30	40	30	50	70
% Small Caps	0	0	0	10	10	0
% International	0	10	10	10	10	0

Chart illustrates sample portfolio asset allocations: Low Risk (those nearing or in retirement); Moderate Risk (middle-aged investors); Aggressive Risk (younger investors).

*\*Allocations are presented only as examples and are not intended as investment advice. Please consult a financial advisor if you have any questions about how these examples apply to your situation. International investing presents risk of currency fluctuations as well as economic and political risks. Government T-bills are guaranteed as to principal and interest if held to maturity.*

<sup>1</sup>An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

<sup>2</sup>Source: Standard & Poor's. Stocks are represented by total returns of the S&P 500, an unmanaged index generally considered representative of the U.S. stock market. Long-term government bond yields are constructed from yields on long-term (10+ years) government bonds published by the Federal Reserve. Past performance cannot guarantee future results. Individuals cannot invest directly in any index.

<sup>3</sup>Source: "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" Financial Analysts Journal, January/February 2000.

**Investors should consider the investment objectives, risks, charges, and expenses associated with a fund carefully before investing. This and other information is available in the prospectus, which can be obtained from your Baird Financial Advisor. The prospectus should be read carefully before investing.**

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