

## MARKET MONITOR DECEMBER 4, 2006

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### Building Blocks and Structured Products

The diversity of modern financial markets can be both a blessing and a curse. With tens of thousands of individual securities, over 7,000 mutual funds, and a similar number of hedge funds, investors can face an overwhelming number of choices. But, with assistance, investors can harness financial markets' diversity for the purpose of diversification, a key principle of investing and a fundamental source of portfolio return and risk management. TIAA-CREF assists long-term investors with diversification in a number of ways, including asset allocation and fund selection guidance. Through the products it offers, TIAA-CREF can help investors implement that guidance in three ways:

- Investors can look to stand-alone, single-asset-class funds and accounts that can be used as building blocks to create individualized diversified portfolios
- They can also use omnibus, partially structured products, such as the CREF Stock Account and TIAA Traditional, that offer a simplified approach to diversification
- Investors can elect a fully packaged product that offers diversification in a single fund, such as the Lifecycle Funds and the Social Choice Account

The foundation of all three approaches is asset allocation based on the principles of modern portfolio theory. Efficient asset allocation takes advantage of the fact that truly different asset class returns are uncorrelated. They react differently to changing market conditions. In other words, stocks, bonds, real estate, and other assets often do well or poorly at different times and this feature can be used to obtain a combination of expected return and risk control that meets an investor's profile. In effect, portfolio diversification offers one of the classic advantages in finance since a well-diversified portfolio may offer a better combination of return and risk than any individual asset class or security. Of course, no method of investing may guarantee a profit or protect against loss.



In the first approach, interested investors can form their own diverse portfolios through the use of individual building blocks, which are stand-alone, single-asset class mutual funds and variable annuity accounts composed of stocks or bonds that stick close to a particular style. Once having chosen an appropriate mix of asset classes, it is critical that the funds used to implement it remain true to their stated investment styles. The intended asset allocation can be undermined by holding growth-oriented mutual funds that buy lots of value stocks from time to time, or small-cap funds that drift to include large-cap stocks. Index funds are one way to gain pure asset class exposure. Carefully managed active funds are another.

The second approach involves implementing a desired asset mix through omnibus, structured products such as CREF Stock and TIAA Traditional, the two largest and most widely used accounts offered by TIAA-CREF. Each is a carefully constructed mix of assets that provide broad asset-class exposure. CREF Stock contains both small, medium, and large-cap domestic equities as well as foreign equities. It has been updated over the years based on advances in the financial field as well as TIAA-CREF Asset Management's own research. Today, it contains a mix of 75% domestic equities and 25% foreign equities. TIAA Traditional features a broad mix of fixed income and real estate assets, including public and private bonds, asset-based securities, mortgages, direct real estate, private equity, and hedge funds. Each year, TIAA-CREF Asset Management engages in a portfolio allocation process based on internal asset-liability and allocation models that help guide investments for TIAA Traditional for the coming year. Depending on an investor's needs, CREF Stock and TIAA Traditional can be used together in different combinations to build an individualized portfolio using just two accounts.

The third approach takes the asset allocation process one step further through the use of fully structured funds that allow investors to use a single fund or account. The Social Choice Account and Managed Allocation Fund offer a static mix of equities and fixed income securities that provide broad diversification. The Social Choice Account screens out certain companies in the Russell 1000 Index of U.S. equities and in the Lehman Aggregate Index of U.S. bonds. The account uses the remaining securities to follow as closely as possible the two indices in a 60-40 stock-bond mix. The Managed Allocation Fund contains a group of equity and fixed-income mutual funds. Both the Social Choice Account and Managed Allocation Fund are rebalanced regularly so that investors can be confident that they can maintain their intended allocations.

The TIAA-CREF Lifecycle Funds are a dynamic mix of 6 equity and bond funds that change as an investor ages. Starting out 35 or more years from retirement with an 80% allocation to four domestic and international TIAA-CREF equity mutual funds and 20% to two TIAA-CREF fixed-income funds, each Lifecycle Fund gradually reallocates so that at the point of retirement the fund is a mix of 35% equity funds and 65% fixed income funds. Each Lifecycle Fund is regularly rebalanced back to the current intended asset allocation.

Each of the three basic approaches to asset allocation can be used by long-term investors to form a portfolio appropriate to their needs and manage it over time. The basic differences among them involve the amount of involvement required of the investor. The building block approach requires the investor to create his or her own portfolio and then to revisit it over time in case there is a need for rebalancing or reallocation. The partially structured accounts can be used to gain broad asset exposure using just two accounts, but they must also be rebalanced and, if needed, reallocated over time. The fully structured Lifecycle Funds are set-and-forget products that provide asset allocation, rebalancing, and reallocation over time.

Are these the only possible options for long-term investing?

The answer is no. TIAA-CREF is working on possible new structured products that may be able to provide additional tools for investors to gain exposure to alternative asset classes, individually managed separate accounts, as well as new retirement income options. A major criteria for new funds, as for existing ones, is their potential to improve our customers' chances for favorable risk-adjusted returns.

**Each of the mutual funds and variable annuity accounts discussed in this publication is subject to various investment risks which could result in possible loss of principal. Please refer to the prospectuses for details on the types of risks applicable to each investment.**

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with more than \$390 billion in combined assets under management (9/30/06). Further information can be found at [www.tiaa-cref.org](http://www.tiaa-cref.org).

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