



FINANCIAL SERVICES  
FOR THE GREATER GOOD®

## Spread it Around

### **Diversifying your investments across asset classes may help reduce risk in your portfolio.**

When creating a portfolio, you may try to select investments individually that you feel will give you the best opportunity to outperform the market. However, most financial experts believe that the most effective way to manage risk and build a portfolio for the long term is through *asset allocation*, or dividing your money among different asset classes such as stocks, bonds, money market and real estate. (Note, however, that there are inherent risks associated with investing, and that maintaining a diversification strategy doesn't guarantee against loss.)

Once you've established a well-diversified portfolio, maintaining a consistent asset allocation may represent a better strategy than trying to “time” the market — attempting to guess whether the financial markets will go up or down for a specific period of time, and then moving funds from one asset class or account to another based on these predictions. Because no one can know for sure how the markets will perform, particularly over the long term, market timing is a strategy that's bound to fail, at least most of the time.

## The Birth of a Theory

Asset allocation is based on modern portfolio theory, which was developed in the 1950s by the economist Harry M. Markowitz, who later received a Nobel Prize for his work. Markowitz measured the risk inherent in various types of investments and developed methods for combining them to maximize the trade-off between risk and return.

Basically, modern portfolio theory says that investors shouldn't view the prospects of a particular investment in isolation, but instead look at each investment and how it fits into an overall portfolio. By combining investments that have a low (or, better yet, negative) *correlation* with each other — that is, investments that don't perform in the same way under similar market conditions — investors will create a less risky portfolio than if they invested only in financial instruments that perform similarly (i.e., have a high correlation).

The advantage of diversifying investments is that each type of investment won't react to the ups and downs of the market in the same way. So by diversifying, you spread the risk in your portfolio around. The result is a more balanced portfolio that can help you withstand drops in the market.

Other studies demonstrate the impact asset allocation has on volatility. For example, in a notable 10-year study of large pension funds, Gary P. Brinson, L. Randolph Hood and Gilbert Beebower found that, over time, more than 90% of the variability of a portfolio's performance is due to allocation among specific asset classes, while less than 5% of the variability of performance results from investment selection.

### **Create a Portfolio**

If asset allocation is a sound investment strategy, your next question may be: "How do I create a portfolio that is right for my needs?" Many financial companies give you an easy way to develop an appropriate allocation strategy: model portfolios diversified among a range of asset classes like stocks, bonds and money market investments. These model portfolios are based on different risk tolerances, investment preferences and "time horizons" (the number of years you have to invest before you use the money, and how many years you'll need that money to last). When investing for retirement, you should diversify your holdings among at least three asset classes, with one of them being stocks.

To learn more about developing an appropriate allocation strategy, call us at **800 842-2776** or use our Asset Allocation Evaluator, available in the "Tools" section of our website at [www.tiaa-cref.org](http://www.tiaa-cref.org).

### **[Footnotes]**

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