Asset Allocation: A Solid Investment Framework

BlackRock

"Don't put all your eggs in one basket." It's a timeless saying that can be applied to many facets of life, cautioning that we not commit all our resources to one prospect or venture, else we could lose it all.

Nowhere does this expression resonate more than within the realm of investing. The evolution and expansion of global capital markets over the years have left today's investors with an increasingly large number of baskets in which to place their financial eggs. An asset allocation strategy can be extremely valuable in helping investors sort through these opportunities and, ultimately, make sound investment decisions that are consistent with their financial goals.

Key Points:

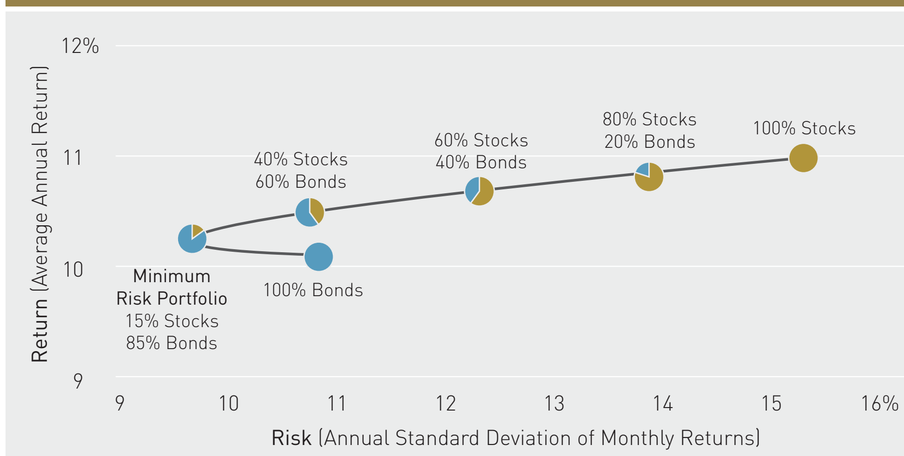
- What Is Asset Allocation?
- The Rationale for Asset Allocation
- "Baskets" for Your Assets
- Mutual Funds as an Effective Allocating Tool

What Is Asset Allocation?

By definition, asset allocation is a strategy whereby an investor builds a portfolio by combining diverse asset categories (e.g., stocks, bonds, cash) in accordance with his or her specific goals, risk tolerance and investment time horizon. It is a thoughtful and scientific process — specific percentages are assigned to each category — that should be distinguished from the related concept of diversification, which more simply means to distribute a portfolio's investment dollars among a variety of investments. In the end, the underlying principle of both practices contends that, on average, a portfolio of different investments will carry lower risk and generate more stable returns than any single investment within the portfolio, as illustrated below.

When done well, asset allocation enables investors to maximize returns within the context of their individual risk tolerances by spreading investments across a wide range of asset classes and styles that perform differently during market cycles.

Allocating Between Stocks and Bonds Can Help Reduce Risk



Sources: BlackRock®; PSN Enterprise. Past performance does not guarantee or indicate future results. Investing involves risk. Stocks are represented by the S&P 500 Index, an unmanaged index that consists of the common stock of 500 large-capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. Stock prices fluctuate with market conditions and may result in loss of principal. Bonds are represented by the Merrill Lynch US Treasuries 10+ Year Bond Index, an unmanaged index which includes US Treasury securities with maturities of greater than 10 years. Bonds held to maturity offer a fixed rate of return. It is not possible to invest directly in an index.

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

The Rationale for Asset Allocation

Market movements — particularly within the equity and fixed income markets — are unpredictable. Market leaders can, and often do, fall out of favor. This uncertainty can be intimidating for investors seeking to build long-term wealth. The fact is, even the most experienced investment professionals are often unable to foresee exactly where the markets will be headed. But what investment professionals do know is that there is a cyclical nature to these movements.

Market rotation occurs on many levels — not just among the major asset classes, but also among different subclasses of investments within each category. Every asset class and subclass exhibits differing risk and return characteristics over various time periods. Therefore, spreading investments among several asset categories with different characteristics allows for more consistent performance under a variety of economic backdrops. If small-cap stocks performed poorly, your losses may be offset by gains in shares of larger, more established companies, and vice versa. Likewise, in a period of weakening global equity markets, exposure to bonds and/or cash could mitigate declines within your portfolio.

Over time, a well-diversified portfolio of investments allows investors to take advantage of gains in strong-performing asset classes and reduce the impact of underperforming asset classes, thereby lessening the portfolio's overall risk exposure and providing more stable — and possibly better — returns.

Spreading investments across several asset categories that behave differently under diverse market conditions may lessen overall risk exposure and allow for more consistent total performance.

Building a Diversified Portfolio Can "Smooth" the Ride

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
BEST	Int'l Equities 27.0%	Treasuries 13.5%	Corporate Bonds 10.4%	Treasuries 11.8%	Small Cap 47.3%	Int'l Equities 20.2%	Int'l Equities 13.5%	Int'l Equities 26.3%	Int'l Equities 11.2%	Treasuries 13.7%
	Small Cap 21.3%	Corporate Bonds 9.4%	Treasuries 6.8%	Corporate Bonds 10.5%	Mid Cap 40.1%	Mid Cap 20.2%	Mid Cap 12.6%	Small Cap 18.4%	Treasuries 9.0%	Cash 2.1%
	Large Cap 20.9%	Mid Cap 8.3%	High-Yield Bonds 5.3%	Cash 1.8%	Int'l Equities 38.6%	Small Cap 18.3%	Large Cap 6.3%	Large Cap 15.5%	Large Cap 5.8%	Corporate Bonds -3.1%
	Mid Cap 18.2%	Cash 6.2%	Cash 4.4%	High-Yield Bonds -1.4%	Large Cap 29.9%	Div Portfolio 11.4%	Div Portfolio 5.9%	Mid Cap 15.3%	Mid Cap 5.6%	Div Portfolio -21.2%
	Div Portfolio 11.3%	Div Portfolio 0.8%	Small Cap 2.5%	Div Portfolio -6.4%	High-Yield Bonds 29.0%	Large Cap 11.4%	Small Cap 4.6%	Div Portfolio 12.4%	Div Portfolio 5.2%	High-Yield Bonds -26.2%
	Cash 4.9%	Small Cap -3.0%	Div Portfolio -1.3%	Int'l Equities -15.9%	Div Portfolio 24.5%	High-Yield Bonds 11.1%	Cash 3.1%	High-Yield Bonds 11.9%	Corporate Bonds 5.1%	Small Cap -33.8%
	High-Yield Bonds 2.4%	High-Yield Bonds -5.9%	Mid Cap -5.6%	Mid Cap -16.2%	Corporate Bonds 7.7%	Corporate Bonds 5.2%	Treasuries 2.8%	Cash 4.9%	Cash 5.0%	Large Cap -37.6%
	Corporate Bonds -1.9%	Large Cap -7.8%	Large Cap -12.5%	Small Cap -20.5%	Treasuries 2.3%	Treasuries 3.5%	High-Yield Bonds 2.7%	Corporate Bonds 4.3%	High-Yield Bonds 1.9%	Mid Cap -41.5%
WORST	Treasuries -2.5%	Int'l Equities -14.2%	Int'l Equities -21.4%	Large Cap -21.7%	Cash 1.2%	Cash 1.3%	Corporate Bonds 2.0%	Treasuries 3.1%	Small Cap -1.6%	Int'l Equities -43.4%

Source: PSN Enterprise. For informational purposes only. It is not possible to invest directly in an index. The information shown does not reflect any particular investment.

Past performance is not a guarantee of future performance.

Large Cap is represented by the Russell 1000 Index, an unmanaged index that measures the performance of the 1,000 largest companies in the Russell 3000 Index. **Mid Cap** is represented by the Russell Midcap Index, an unmanaged index that measures the performance of the 800 smallest companies in the Russell 1000 Index. **Small Cap** is represented by the Russell 2000 Index, an unmanaged index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index. **International Equities** are represented by the MSCI EAFE Index, an unmanaged index that measures the total returns of developed foreign stock markets in Europe, Asia and the Far East. **Treasuries** are represented by the Barclays Capital Treasury Bond Index, an unmanaged index that covers the US Treasury market with an average maturity of approximately 9 years and a duration of between 5 and 6 years. **Corporate Bonds** are represented by the Barclays Capital Credit Bond Index, an unmanaged index that covers all public, fixed rate, nonconvertible investment-grade domestic corporate debt. Issues included in this index are rated at least Baa by Moody's Investors Service. **High-Yield Bonds** are represented by the Barclays Capital High Yield US Corporate Index, an unmanaged index that covers the universe of fixed rate, non-investment-grade debt. **Cash** is represented by the ML US Treasury Bill 3 Month Index, an unmanaged index based on the value of the 3-month Treasury bill assumed to be purchased at the beginning of the month and rolled into another single issue at the end of the month. **Diversified Portfolio** is represented by an equal allocation to the eight asset classes described here.

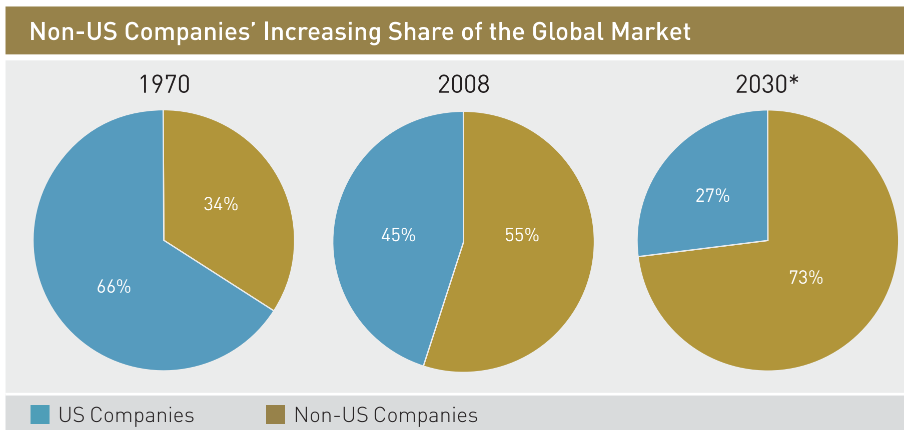
"Baskets" for Your Assets

Before investors can implement an effective asset allocation strategy, they should familiarize themselves with the various "baskets" in which they can put their investments. Among the most common asset classes are stocks, bonds and cash:

- Stocks. Generally speaking, stocks have been shown to generate the highest returns among the three primary asset classes over the long-term. Their short-term fluctuations in price, however, produce a high level of market risk (the possibility that the value of an investment will decrease due to shifts in market factors).
- Bonds. While bonds also fluctuate in value, they tend to be less volatile than stocks as a considerable portion of their returns comes in the form of income. However, the relative safety and stability of bond investments comes at the cost of more modest returns.
- Cash. Cash and cash equivalents, such as Treasury bills, certificates of deposit and commercial paper, entail the least amount of risk, but offer comparatively lower rates of return than stocks and bonds.

Opportunities also exist beyond these traditional groupings. Investing outside US borders, for example, affords the potential for enhanced returns with reduced overall portfolio risk. Consider this: at year-end 2008, the world's combined stock market capitalization was $18.2 trillion; the US share of this aggregate figure was 45%, down from 66% in 1970. Thus, a US investor limited to solely domestic stocks would be missing out on more than half of the world's investment opportunities.

Non-US Companies' Increasing Share of the Global Market



* Projected data for the year 2030 are calculated using the rate of growth since 1970. Source: Standard & Poor's; Morgan Stanley Capital International. US companies represented by the S&P 500 Index. Non-US companies represented by the MSCI EAFE Index.

Investors seeking to further vary their portfolio holdings may wish to tap into alternative asset classes, such as commodities, real estate and foreign currencies, which are fundamentally diverse and whose returns are, for the most part, independent of stocks and bonds—and each other. Adding broad exposure to any single or a combination of these non-correlative investments can help balance investors' portfolios and minimize volatility. Less volatility signifies lower risk and a greater likelihood of achieving expected returns.

Bear in mind that investing in securities of foreign issuers involves risks, including risks related to foreign currency, limited liquidity, less governmental regulation, and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are often heightened in emerging/developing markets

It is important to note that asset allocation requires regular maintenance. Occasionally, investors may need to rebalance their portfolios (i.e., return them to the original mix of stocks, bonds, cash), as target asset allocations can shift, either naturally or due to market movements, and cause their investments to fall out of alignment with their goals and/or risk tolerance. When to consider rebalancing depends on a variety of factors, but a good rule of thumb is to designate a set time interval (e.g., every 12 months).

or smaller capital markets. Alternative asset classes typically carry category-specific risks too. As always, investors should review these risks to evaluate the suitability of any individual investment within their portfolios.

Finally, it is important to note that in each of the major asset classes, there are many subclasses from which to choose. Within the world's stock markets, for instance, investors can choose investments based on market capitalization (e.g., small cap, large cap); investment style (e.g., growth, value); or sector (e.g., technology, healthcare, natural resources). Similarly, bond markets are not one-dimensional. There are important considerations, such as sector (e.g., government, corporate, tax-exempt), credit quality (high grade to low grade) and maturity (long, intermediate, short). Diversifying among several subcategories within each of the major asset classes can potentially further reduce the variability of returns in a portfolio.

Mutual Funds as an Effective Allocating Tool

As markets have evolved and expanded over time, the opportunities for diversification have grown considerably — as has the difficulty of allocating assets in an optimal manner. Mutual funds can be a very effective, and simple, asset allocation tool, sparing investors of having to build their own portfolios of individual investments — a more expensive and time-consuming task best left to the professionals.

For starters, many funds make asset allocation central to their investment objective. Relying on their rigorous research capabilities and investment expertise, fund managers can differentiate between the market segments that afford greater appreciation potential and those that have less compelling prospects. What's more, they generally have a more acute understanding of how underlying securities or funds work together, which is critical to understanding, and then effectively managing, total risk exposure.

Remember that using asset allocation and diversification as part of an investment strategy does not guarantee a profit or protect against loss in broadly declining markets. Before investing in any mutual fund, ask for a prospectus and read it. If you have any questions, and you probably will, call your financial professional or the fund company to get answers.

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