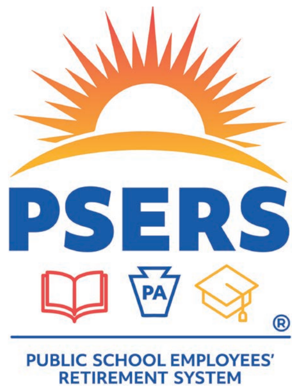



SPECIAL REPORT

# Asset allocation

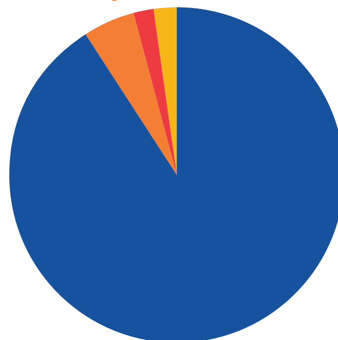
## Balancing risk and reward with “class”

Life is full of risks and rewards. As a Public School Employees’ Retirement System (PSERS) Defined Contribution (DC) Plan participant, the reward for taking on risk is the potential to make more money. Of course, you can also lose more money. The key is finding a balance between your risk tolerance and reward potential. Asset allocation can help.

### A powerful decision

The most significant decision you will make when building an investment portfolio is determining the asset allocation.[1] Dividing your investments among different asset classes can be more important than the actual investment choices you make. 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.

### A portfolio with “class”

Asset allocation involves choosing a portfolio by selecting combinations of investments to meet your specific needs and goals. 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 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 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.

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## 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 your long-term financial goals. If too much risk is included, however, the invested money may not be there when you need it. The key is finding the right balance between risk and reward that works within your unique time horizon and risk tolerance.

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

## Target date investments

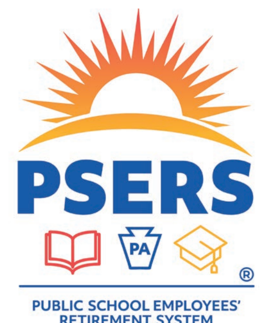
An alternative to asset allocation is to invest in a target date investment based on your date of birth and estimated normal retirement age. Target date investments are professionally managed and periodically adjust with a specific target retirement date in mind. Professional investment managers invest your money in a mix of funds across a variety of asset classes to create a diversified investment portfolio, guided by the number of years until retirement. This gives you the ability to diversify within a single investment option.

Of course, using asset allocation as part of any 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. 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.

For PSERS members in Class T-G, Class T-H, and Class DC, you can review and change your asset allocation in your PSERS DC account online through the PSERS Member Self-Service (MSS) Portal. Log into the MSS Portal, go to the Voya Account Access box to access your PSERS DC account, then go to *Investments & Research > Manage Investments* to review and reallocate how your current and future contributions are invested.

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