Diversification: Balancing Risk and Reward.

Diversification is a way of managing risk that may be a key to long-term investment success. In simple terms, it means not putting all your "eggs" in one "basket." There are several opportunities for an investor to diversify their investments.

They say variety is the spice of life. But when it comes to investing, variety can be a key to long-term success. This is why so many investment professionals advertise diversification as a potential benefit of their products or services. But just what does diversification mean? Why might it be beneficial?

How Diversification Works

Simply put, diversification is a means of helping to manage risk. The concept is as simple as the age-old analogy of not putting all your eggs in one basket. Imagine your goal is to move your eggs from Point A to Point B. If you put all your eggs in one basket, you run the risk of dropping that single basket and losing all of your eggs. If you spread your eggs across several baskets, however, you have reduced the risk of losing all your eggs if a basket is dropped since you have extra eggs tucked in other baskets.

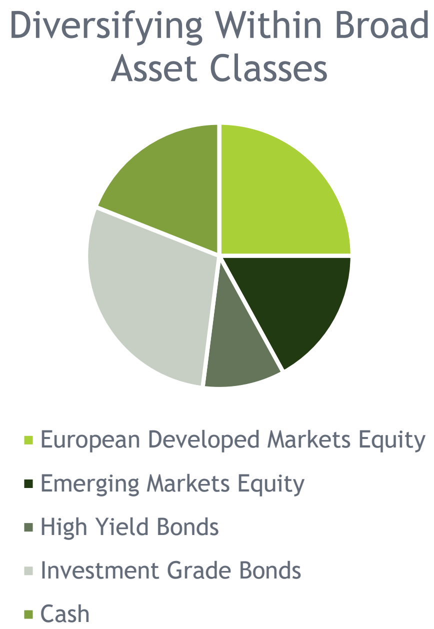
Think of your money as eggs and asset classes as baskets that can carry your money from Point A (your current portfolio) to Point B (your investment goals). Each asset class (such as stocks, bonds, and cash) has unique characteristics that cause it to perform differently under different market conditions.

Investors who put all their money (or, eggs) in one asset class (or, basket) run the risk of losing a significant amount of money in the event that particular asset class does not perform well in a given market condition. Those who diversify their investments across a range of asset classes, however, would likely mitigate the effects of adverse movements in any one asset class.

Diversify your Diversification

Diversification can be taken a step further by allocating investments across categories within the broader asset classes. (See Exhibit 1 on the following page for a hypothetical example.) Since different types of bonds are inherently more volatile (high-yield bonds, for example) than others (investment-grade bonds, for example) investors could benefit from allocating their money across bond types according to their level of risk tolerance. Additionally, because performance of both stocks and bonds in a given period might be affected by where the holdings reside, investors can benefit from allocating both asset classes across different regions or countries.

Exhibit 1



Source: SEI. For illustrative purposes only.

Note that diversification does not protect investors against market risk nor does it insulate against market volatility. All asset classes undergo market volatility, however they do so in different ways at any point in a market cycle or an idiosyncratic market event. A well-diversified portfolio of uncorrelated assets will add layers of diversification which should dampen the effects of market volatility.

What This Means to You

With perfect foresight, you could simply allocate all of your money to the top-performing asset class each year. Without this divine ability, however, the best option is to invest in a variety of assets (or sub-asset classes, regions or countries) that overall meet your risk-tolerance levels and react differently to a range of market forces. This serves to help moderate the ups and downs of portfolio performance, giving you a better chance to reach your long-term goals.

Important information

Information provided by SEI Investments Management Corporation (SIMC). This information is for education purposes only and should not be relied upon by the reader as research or investment advice.

Investing involves risk, including possible loss of principals.

Bonds are subject to interest rate risk and will decline in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments.

International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from social, economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Diversification does not ensure a profit or guarantee against a loss. Diversification may not protect against market risk.