

# The Art and Science of Asset Allocation

## A Strategy for Building Your Optimal Portfolio

One of the most crucial financial decisions you can make is where to invest your money. According to the Investment Company Institute, more than 56,000 mutual funds existed worldwide in 2005.<sup>1</sup> So with virtually limitless choices, how do you create a portfolio that reflects your unique financial goals and needs? Consider an investment strategy called asset allocation.

### Buffer the Effects of Market Volatility

Asset allocation is an investment strategy that seeks to balance risk and reward in your portfolio by spreading investments over several types of asset classes—such as stocks, bonds and cash. Historically, it's proved to be the primary tool for achieving an investor's ideal balance of risk and reward.

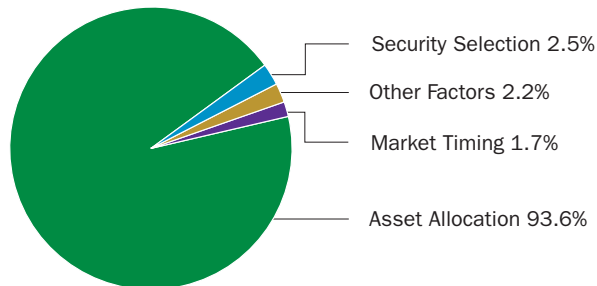
### Why Is Asset Allocation So Important?

Because asset classes respond differently to changing market conditions. For instance, when stocks suffer a decline, bonds may rally. Or if interest rates rise, the value of bonds may decrease. So if your portfolio contains too much of one asset class, you will have a higher risk of losing money.

A good illustration of asset allocation is the pencil experiment. Take one pencil and break it in half. You've just demonstrated how easy it is for a single asset class to fall apart. Now hold a bundle of pencils in your hands and try to snap the group in half—it's next to impossible. Likewise, the strength and balance of a portfolio comes from a combination of asset classes.

### The Importance of Asset Allocation

Research shows that a properly allocated portfolio is the most critical factor in explaining the difference in returns across portfolios.



Source: *Financial Analysts Journal*, "Determinants of Portfolio Performance," by Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower, July/August 1986.

<sup>1</sup>Source: Investment Company Institute, ICI Fact Book 2006.

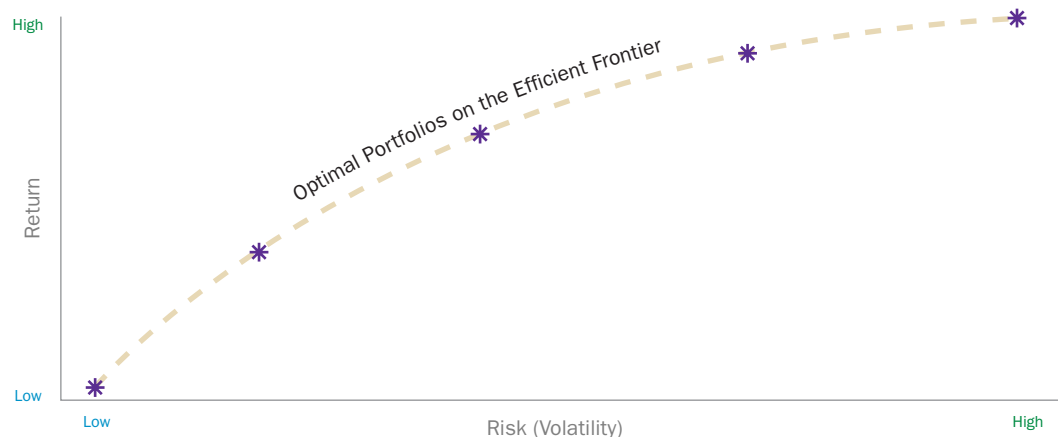
## Stake a Claim on the Efficient Frontier

Asset allocation was first developed by Nobel prize-winning economist Harry Markowitz. His research proved that overall risk could be reduced in a portfolio by diversifying investments across a strategic combination of asset classes. Markowitz illustrated how much risk a given portfolio would incur versus its expected return. The resulting graph is known as the efficient frontier.

Using the efficient frontier to develop an asset allocation strategy allows your financial advisor to use your risk tolerance and financial goals to determine how your portfolio should be constructed—the first step to a properly allocated portfolio. If your portfolio is on the curve, it should provide the most effective way to reach your goals based on your risk tolerance and specific needs. If your portfolio doesn't land on the curve, it's considered less efficient—meaning you may be taking on more risk than you need to reach your goals, or you may not be exposed to enough return potential to reach your goals.

### Where Is Your Portfolio on the Efficient Frontier?

This chart illustrates an example of several optimized portfolios, represented by stars, using the concept of the efficient frontier. These portfolios are considered efficient because each offers a fair trade-off between risk and return and takes into consideration an investor's unique investment needs. An optimized portfolio will not perform the same way as an investment in a single asset class. That means an optimized portfolio may have lower returns in the short term and will not protect against every risk. No investing strategy can overcome all market volatility or guarantee future results.



Your goal should be to invest in a mix of asset classes that falls in an area of the efficient frontier curve that offers both a risk level and return potential you're comfortable with over the length of time you plan to invest.

## Talk to a Financial Advisor

Whether you're launching a career, starting a family, saving for college or planning for retirement, you want a financial plan suited to your unique goals. A partnership with a financial advisor is a good starting point. At AIM, we understand the importance of selecting a financial advisor, as well as an investment company, with the depth of experience and breadth of products to help meet your needs. Talk to an advisor to learn more about how an investment strategy and AIM products may help put you on the path to achieving your goals.

**Not FDIC insured | May lose value | No bank guarantee** Consider the investment objectives, risks and charges and expenses carefully. For this and other information about AIM funds, obtain a prospectus from your financial advisor and read it carefully before investing.

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