Risk is a fundamental part of investing. While risk cannot be eliminated, it can be managed. For most investors, the principal concern is to reduce their risks without penalizing their potential returns.

Some respond to setbacks by moving all their money out of stocks or bonds and into money market funds or certificates of deposit. This may seem to make sense during a period of uncertainty, but trying to “time” the market is seldom successful. Over the longer term, one of the best ways to lower a portfolio’s risk of share price declines—and still earn attractive returns—is to diversify.

Diversification, or spreading your assets across a variety of different investments, is perhaps the single most important rule you can follow as an investor. The value of diversification is often underscored by events in the financial markets, such as sharp drops in stock prices. If you include a variety of investments in your portfolio, its overall performance should be less volatile—and you should have less risk—than if you put all your money in one type of investment.

Diversification offers this benefit because each kind of investment responds differently to changes in the economy or the investment marketplace. If you own a variety of assets in different markets, a decline in one can often be balanced by others that are stable or going up.

For example, foreign stock and bond markets do not always track the U.S. markets’ direction. In U.S. dollar terms, some may outperform the U.S. over certain periods. Therefore, owning a mix of both domestic and international stocks and bonds could reduce the overall volatility of a portfolio because some holdings may rise in value while others are declining. Of course, diversification cannot assure a profit or protect against loss in a declining market.

### Insights

**Diversified Versus Single-Asset Portfolios**

How would a widely diversified portfolio have fared over the last two decades compared with ones invested entirely in money market instruments, bonds, real estate, or stocks?

As you can see from the 20-Year Performance chart, several portfolios performed well on average during the 20 years ended December 2007. A diversified portfolio, which was evenly divided among U.S. stocks (represented by the S&P 500 Stock Index), foreign equities (MSCI EAFE Index), domestic bonds (Citigroup Broad Investment-Grade Bond Index), international bonds (J.P. Morgan Non-U.S. 1+ Year Government Bond Index), real estate (Dow Jones Wilshire Real Estate Index), and money markets (Citigroup 3-Month Treasury Bill Index), had returns that modestly lagged the best performers for the period.*

But performance is only one part of the picture. The Fluctuation of Returns chart on the next page shows the difference between each portfolio’s best and worst years during the 20-year period. For instance, U.S. stock returns ranged widely. The diversified portfolio, however, had a variability...
In its returns only modestly greater than U.S. bonds—even though its total returns for the period were notably higher than U.S. bonds.

In practical terms, the higher volatility of stocks and bonds compared with money markets means higher risk. Suppose all your money was invested in stocks and you needed to sell some of your holdings to make a down payment on a house. If stocks were depressed when you needed to sell, you could be forced to take a loss. Owning other investments would give you more flexibility in raising the needed cash, allowing you to hold your stocks until prices improved.

Volatility is also hard on the nerves. Even if you did not have a pressing need for money, sizable price changes might tempt you to sell an investment at just the wrong time.

If greater stability is the goal, why not invest exclusively in money market securities? You could do that, but there are drawbacks. While money market instruments provide liquidity and low risk, their average annual return for the 20-year period was more than half that of the diversified portfolio—a high price to pay for greater stability. Moreover, money market returns provided the smallest margin over inflation in this period.

■ The Advantages of Variety

Over the long run, owning a wide variety of investments is the best strategy for almost everyone because most people hope their investments will meet a number of different goals. You may want to save for college expenses or your own retirement, to start a business, to supplement your pension, to set up an “emergency” fund—or pursue several goals at once.

While no single type of investment can achieve all your goals, each one can make an important contribution to your long-term plan. Money market securities can provide a foundation of stability and liquidity that is ideal for the cash reserve you may need to tap on short notice. Bonds are a good choice for steady, high income, while stocks have the greatest potential for superior, long-term returns and protection against inflation. Adding real estate can provide a balanced package of income, appreciation potential, and some inflation protection.

A diversified portfolio that includes the basic types of financial assets can provide attractive performance over time with moderate volatility. Of course, you must remember that diversification can reduce, but not eliminate, risk and cannot assure a profit or protect against loss in a declining market. Nevertheless, it can help you meet your important financial goals.

Request a prospectus or a briefer profile by calling 1-800-541-8803; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

*J.P. Morgan Non-U.S. 1+ Year Government Bond Index tracks government bonds in 18 international markets, as well as the EMBI Plus, which tracks 17 more countries. Source: J.P. Morgan Markets.

S&P 500 Stock Index tracks the stocks of 500 U.S. companies.

MSCI EAFE Index tracks the stocks of about 1,000 companies in Europe, Australasia, and the Far East (EAFE).

Citigroup Broad Investment-Grade Bond Index tracks U.S. government debt obligations maturing in more than one year.

Dow Jones Wilshire Real Estate Index is a market capitalization-weighted index composed of publicly traded real estate investment trusts and real estate operating companies.

Citigroup 3-Month Treasury Bill Index tracks short-term U.S. government debt instruments.

Insights reports provide background information on many aspects of investing.