



Asset Allocation Helps Investors Balance Risk and Rewards

Virtually every investor has crystal-clear, 20/20 hindsight. If only we had invested in those now-famous companies which posted explosive gains. The radical performance of a handful of individual stocks tempt investors to bet heavily on a few companies with such extreme potential. But academic research suggests a potentially better strategy might be to buy a wide array of different stocks, such as those in a typical mutual fund.

Imagine a hypothetical investor with \$1,000. His choices are to buy some combination of three investments: one doubles in a year, one returns 30% and the third loses 10%. The investor doesn't know which investment is which.

- Choice 1: Pick only one of the three investments, hoping it's the one that doubles. This would offer a one-in-three chance of picking the winner and coming away with \$2,000.
- Choice 2: Split the money equally among the three investments. From a mathematical as well as a risk perspective, this would have been a better choice. By diversifying, the investor would wind up with \$1,400. True, that is less than the \$2,000 he would pocket with the big winner. But it is better than he would fare if he bet the entire \$1,000 on one of the other two investments. Those two would leave him with either \$1,300 or \$900.

The Law of Averages

By trying to keep up with the market, investors may spend too much time aiming darts at potentially explosive investments. Only a few stocks actually post huge gains, and those occasional screamers make the typical stock appear to lag behind the average gain by several percentage points annually. This explains mathematically why stock managers often point to the market's narrow advances. While the growth rates of a handful of individual companies rocket above expectations, most stocks only perform moderately. Those S&P 500¹ investments that soared in recent years propelled the index and made the average performers look like duds.

Balance Through Diversification

Considering that one cannot predict which investments will experience phenomenal growth, it may be wisest to cast the net wide. In order to keep up with market averages, the investor is mathematically better off allocating assets to a broad range of diverse investments. This is one advantage of an investment strategy that includes mutual funds. A wide casting of the net may not bring in that huge marlin your client saw leaping over the horizon, but he's likely to hoist up more than enough tuna and grouper to feed the crew.

Catering to Investment Style

As your clients determine an investment strategy, they must consider how much time they can afford to wait for returns, as well as how much sleep they are willing to lose as the market fluctuates. Asset allocation with mutual funds may allow the investor to rest easier knowing that even if he has not been able to predict the takeoff of an individual stock, he can ride out market fluctuations.

For more information about asset allocation, contact your internal wholesaler.

Financial Dealer Division (FDD)
800-998-4246

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