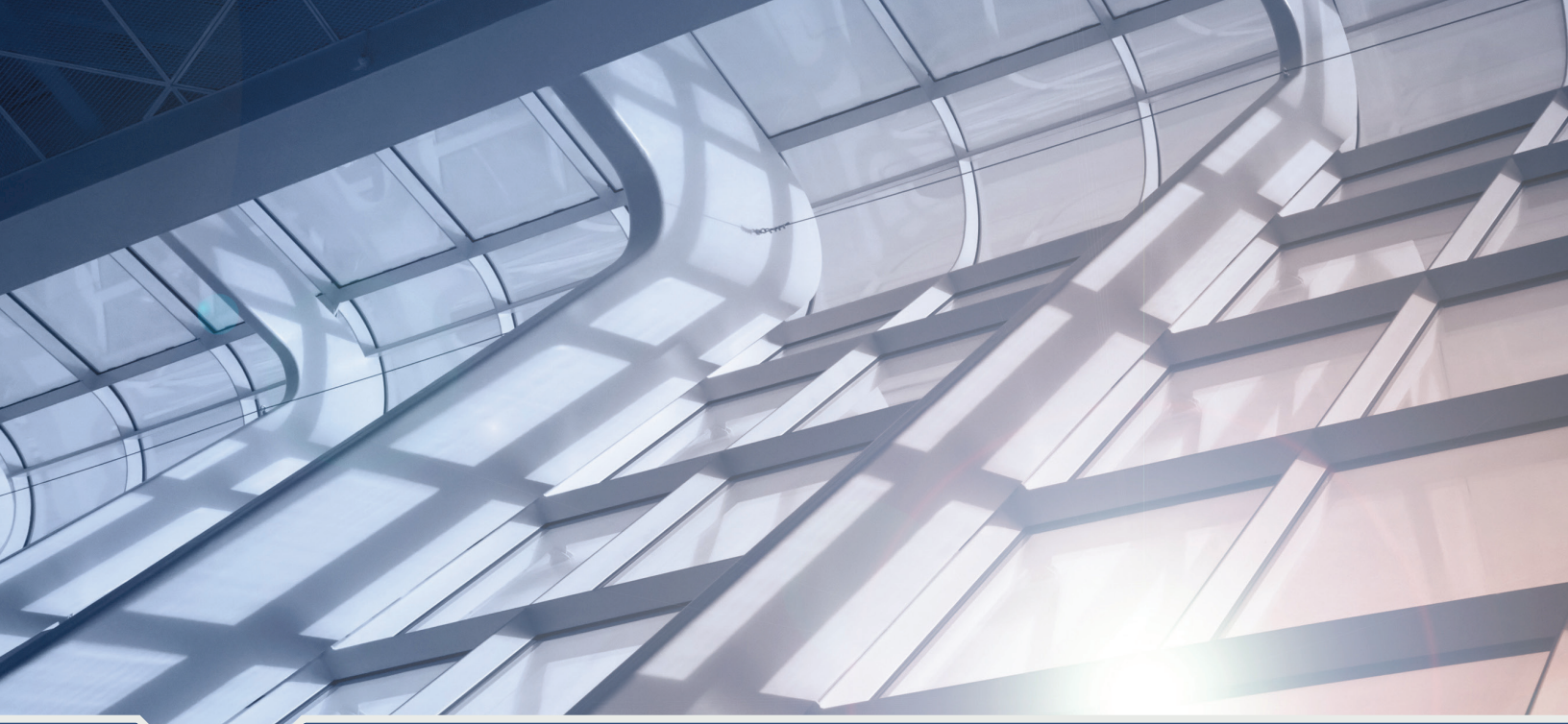


Asset Allocation Essentials

INVESTMENT ESSENTIALS

MANAGING PORTFOLIO

AMG Funds

Introduction to Asset Allocation

Allocating investments among different asset classes is a key strategy to help manage risk and potentially increase gains. Consider it the opposite of "putting all your eggs in one basket."

The first step to understanding optimal asset allocation is defining its meaning and purpose, and then taking a closer look at how allocation can be beneficial and determine the right asset mix to achieve it.

What Is Asset Allocation?

Asset allocation is the strategy of dividing an investment portfolio across various asset classes like stocks, bonds and cash and equivalents securities. Essentially, asset allocation is an organized and potentially effective method of diversification.

Options typically fall within three classes: stocks, bonds and cash. Within these three classes are subclasses or alternatives that can include:

Large cap stock: Shares issued by large companies with a market capitalization generally greater than $10 billion.

Mid-cap stock: Shares issued by mid-sized companies with a market cap generally between $2 billion and $10 billion.

Small cap stock: Shares issued by smaller-sized companies with a market cap of less than $2 billion. These issuers tend to have the highest risk due to lower liquidity, access to fewer financial resources, unproven business models and limited public information.

International stocks: Securities that are issued by foreign companies and listed on a foreign exchange. International securities allow an investor to diversify outside of his or her country, but they also have exposure to country risk.

Emerging markets: Stocks from the financial markets of a developing country. Although investments in emerging markets offer a higher potential return, there is also higher risk, often due to political instability, country risk and lower liquidity access to fewer financial resources, unproven business models and limited public information.

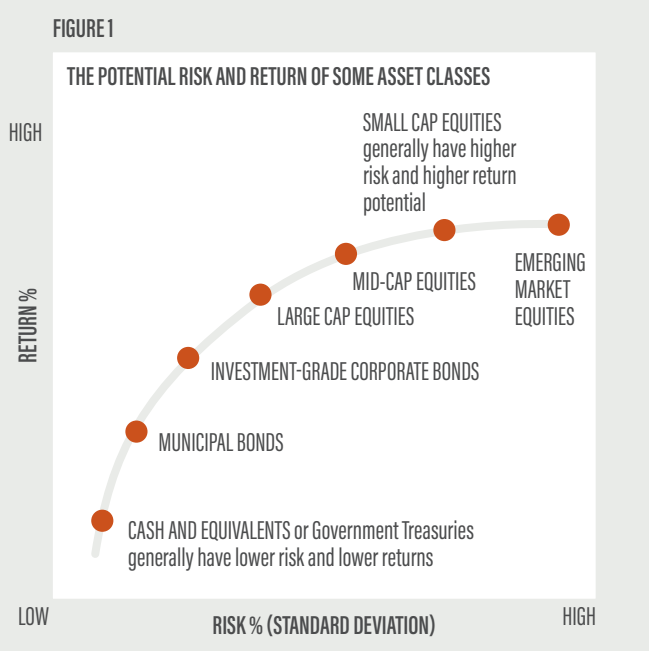
Fixed-income securities: The fixed-income asset class comprises debt securities that pay the holder a set amount of interest, periodically or at maturity, as well as the return of principal when the security matures. These securities tend to have lower volatility than equities and lower risk. Even though the issuer promises an income payment, there is a risk of default and price fluctuation. Fixed-income securities include corporate, government and municipal bonds.

Money market: The money market is where financial instruments with high liquidity and very short maturities are traded. It is used by participants as a means for borrowing and lending in the short term, with maturities that usually range from overnight to just under a year. Among the most common money market instruments are eurodollar deposits, negotiable certificates of deposit (CDs), bankers acceptances, U.S. Treasury bills, commercial paper, municipal notes, federal funds and repurchase agreements (repos).

Real-estate investment trusts (REITs): REITs trade similarly to equities, and are companies that meet certain requirements and own, operate or finance income producing real estate.

Maximizing Return & Managing Risk

The main goal of allocating assets is to manage risk while meeting an expected level of return. Of course to maximize return and manage risk, an investor needs to consider the risk-return characteristics of the various asset classes.



This is a hypothetical illustration of general risk and return characteristics of certain asset classes. This is not a guarantee of any specific investment result or a recommendation to invest in any specific asset class. Investing involves risk including possible loss of principal.

Equities generally have the highest potential return, but also the highest risk. On the other hand, U.S. Treasury securities generally have the lowest risk because they are backed by the full faith & credit of the U.S. government, but they also provide the lowest potential return.

This is the risk-return tradeoff. Keep in mind that high-risk choices are better suited for investors who have a high risk tolerance (can accept wide fluctuations in value) and who have a longer time horizon to recover from losses.

It is because of the risk-return tradeoff—that the potential for return rises with an increase in risk—that diversification through asset allocation is important. Since different assets have different risks and market fluctuations, proper asset allocation has the potential to reduce the effects from the ups and downs of one single class of securities on the entire portfolio.

So, while part of the portfolio may contain more volatile securities—which have been chosen for their potential of higher returns—the other part of the portfolio devoted to less volatile assets remains more stable. Because of the risk management it can offer, asset allocation is key when seeking to maximize returns while reducing risk.

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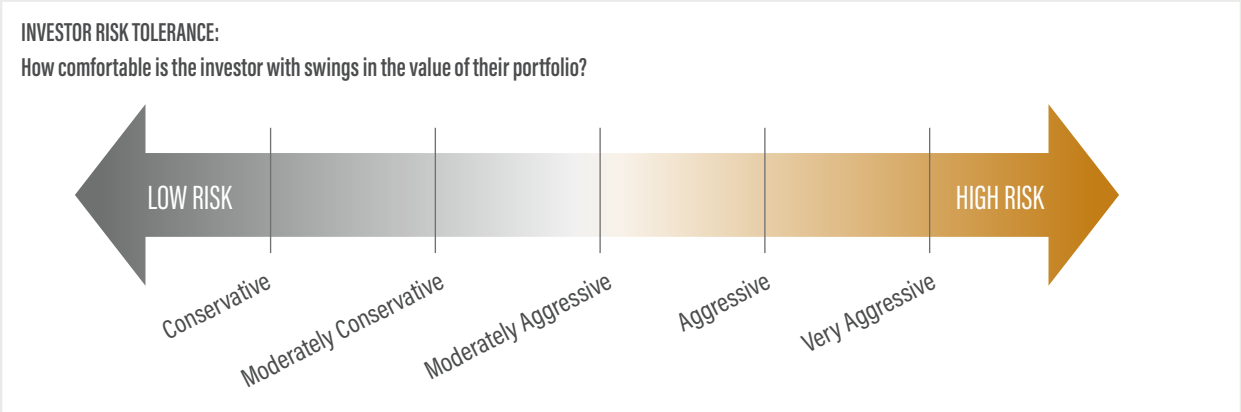
Deciding What Is Right

As each asset class has varying levels of return and risk expectations, investors should consider their risk tolerance, investment objectives, time horizon and available capital as the basis for their asset composition. Investors with a long time horizon and larger sums to invest may feel more comfortable with high risk, high return potential options. In contrast, investors with smaller sums and shorter time spans may feel more comfortable with lower risk, lower return potential allocations. Investors should also consider obtaining professional guidance on investing.

A simplified way to look at asset allocation is to consider some basic allocations among asset classes in terms risk:

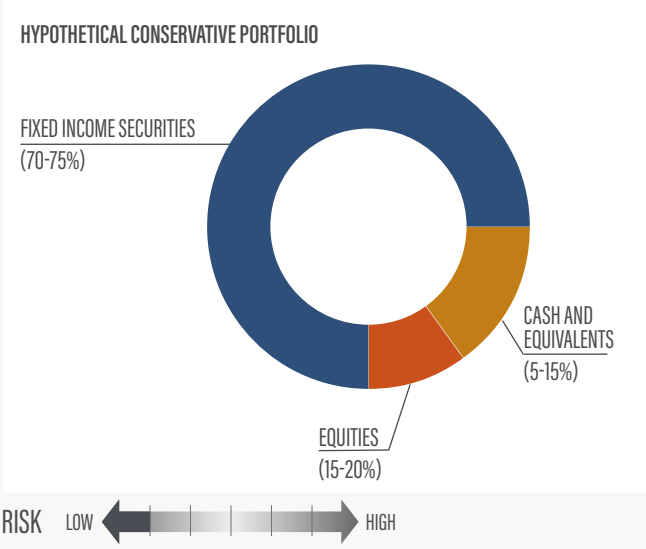


> Allocating investments among different asset classes is a key strategy to help manage risk and potentially increase returns. Consider it the opposite of "putting all your eggs in one basket."

Conservative Portfolios

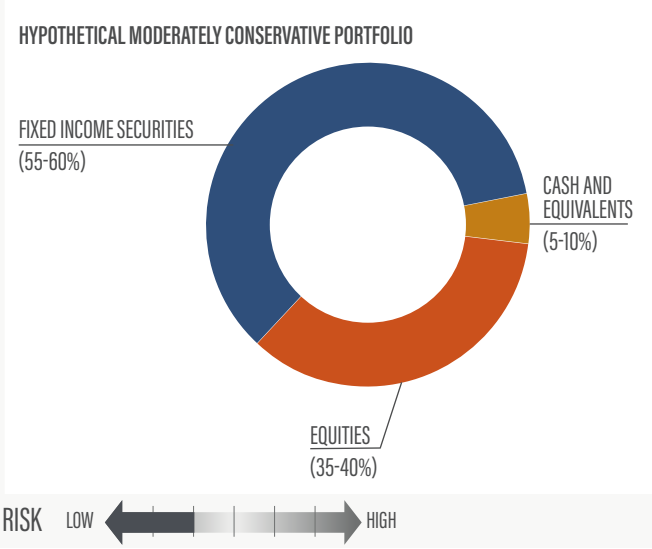
Conservative portfolios generally allocate a large percent of the total portfolio to lower-risk securities such as fixed-income securities and cash and equivalents. The main goal of a conservative portfolio is to protect the principal value of the portfolio (the money originally invested), and to a lesser extent income and capital appreciation. These models are often referred to as "capital preservation portfolios."

Even if the investor is very conservative and prefers to avoid the stock market entirely, some exposure can help offset the effects of inflation. One could invest the equity portion in high-quality blue chip companies, mutual funds or exchange traded funds.



Moderately Conservative Portfolios

A moderately conservative portfolio can be ideal for those who wish to seek to preserve a large portion of the portfolio's total value, but are willing to take on a higher amount of risk to pursue more inflation protection. A common strategy within this risk level is called "current income." With this strategy, an investor can choose securities that pay a high level of dividends or coupon payments. This strategy is common with conservative mutual funds and exchange traded funds.

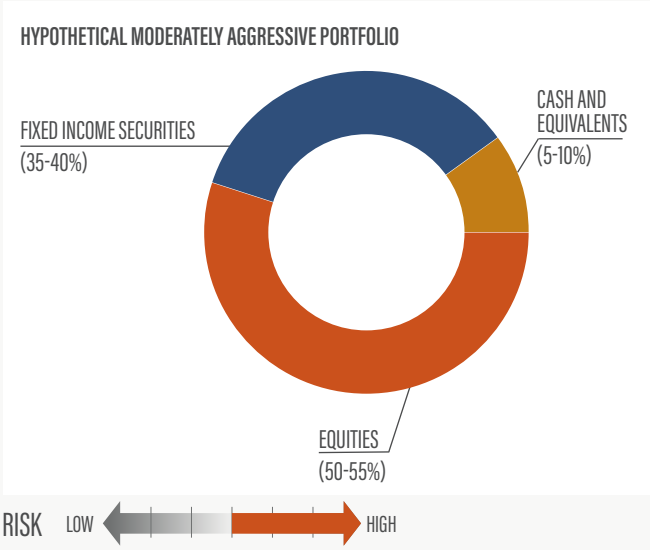


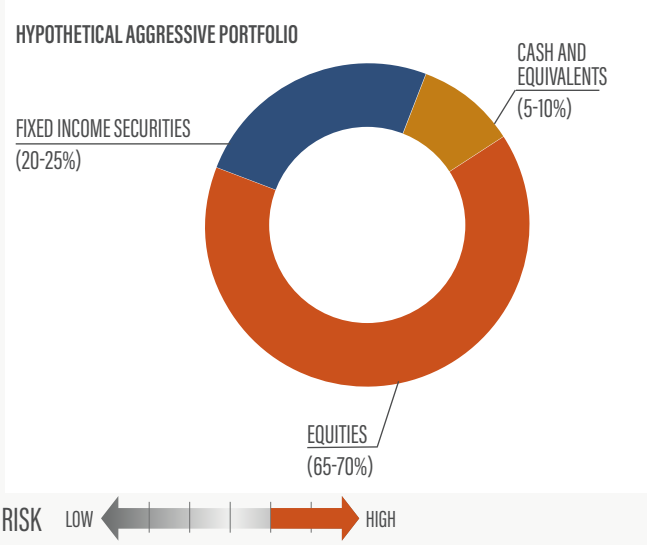
Moderately Aggressive Portfolios

Moderately aggressive portfolios are often referred to as "balanced portfolios" as the asset composition is divided almost equally between fixed-income securities and equities, in order to provide a balance of growth and income potential. Since moderately aggressive portfolios have a higher level of risk than conservative portfolios, this strategy may be best for investors with a longer time horizon (generally more than five years) and a medium level of risk tolerance.

Aggressive Portfolios

Aggressive portfolios mainly consist of equities, so their value tends to fluctuate widely. If you have an aggressive portfolio, your main goal is to obtain long-term growth of capital. As such, the strategy of an aggressive portfolio is often called a "capital growth" strategy. To provide some diversification, portfolios with aggressive investments usually add some fixed-income securities.





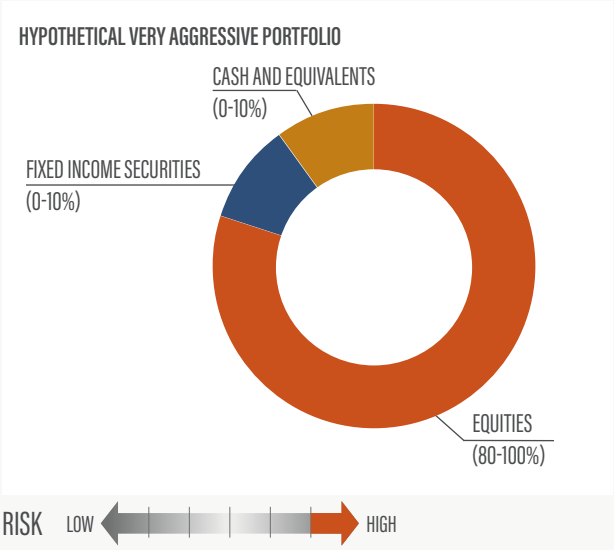
Asset Allocation Strategies

While deciding how to allocate their portfolio, investors should keep in mind several allocation strategies and their goals. Each one offers a different approach based on the investor's time horizon, goals and risk tolerance.

> Asset allocation is a fundamental investing principle because it has the potential to help investors maximize profits while managing risk.

Very Aggressive Portfolios

Very aggressive portfolios consist almost entirely of equities. With this type of portfolio, the main goal is aggressive capital growth over a long time horizon. Since these portfolios carry a considerable amount of risk, the value of the portfolio varies widely.



Tailor Your Allocations to Your Needs

Note that the outline of model portfolios and the associated strategies offer only a loose guideline—you can modify the proportions to suit your own individual investment needs. A financial advisor may be able to help. How you fine tune the model that is most appropriate depends on your future needs for capital, your risk tolerance and time horizon.

For instance, you may want to further divide the equities or fixed-income securities in the portfolio among subclasses of securities. By doing so, you can achieve a specialized risk-return potential within one portion of your portfolio.

Also, the amount of cash, and cash equivalents instruments you place in your portfolio will depend on the amount of liquidity and stability you need. If you need investments that can be liquidated quickly or you would like to seek to maintain the current value of your portfolio, you might consider putting a larger portion of your investment portfolio in cash and equivalents or short-term fixed-income securities. Those investors who do not have liquidity concerns and have a higher risk tolerance usually will have a smaller portion of their portfolio within these instruments.

The Importance of Maintaining Your Allocated Portfolio

Once an investor has chosen their portfolio investment strategy, it is important to conduct periodic portfolio reviews, as the value of various assets will change. This affects the weighting of each asset class, meaning over time a portfolio can grow from containing primarily one type of asset class to another. For example, if you start with a moderately conservative portfolio, the value of the equity portion may increase significantly during the year, suddenly resulting in a more equity heavy portfolio. This makes the portfolio more like that of an investor practicing a balanced portfolio strategy, which is higher risk.

In order to reset the portfolio back to its original state, it needs to be rebalanced. Rebalancing is the process of selling portions of a portfolio that have increased significantly and using those funds to purchase additional units of assets that have declined slightly or increased at a lesser rate. This process is also important if the investment strategy or tolerance for risk has changed. (Please also read *The Benefits of Rebalancing Your Portfolio* article in our Investment Essentials series.)

Asset Allocation in Conclusion

Asset allocation is a fundamental investing principle because it has the potential to help investors maximize profits while managing risk. The different asset allocation strategies described above cover a wide range of investment styles, accommodating varying risk tolerances, time frames and goals.

Once you have chosen an appropriate asset allocation strategy, remember to conduct periodic reviews of your portfolio to help ensure you are maintaining your intended allocation and are still on track to your long-term investment goals.

Contact your financial advisor to learn more about INVESTMENT ESSENTIALS or please visit amgfunds.com/essentials for more information.

About AMG Funds

The largest network of institutional quality boutique investment solutions through a single point of access

Unrivaled access to insights of over 30 independent and autonomous investment managers

More than 100 actively managed products covering the risk spectrum for investors searching beyond the index

Investing involves risk, including possible loss of principal.

Diversification does not guarantee a profit or protect against a loss in declining markets.

Large-capitalization companies may underperform when stocks of large-capitalization companies are out of favor.

Mid-capitalization stocks are generally subject to greater price volatility, have lower trading volume, and less liquidity than large-capitalization stocks.

Small-capitalization stocks are subject to risks associated with erratic earnings patterns, competitive conditions, limited earnings history and a reliance on one or a limited number of products.

Investments in international securities are subject to certain risks of overseas investing including currency fluctuations and changes in political and economic conditions, which could result in significant market fluctuations. These risks are magnified in emerging markets.

Fixed income securities are subject to interest rate risk. An increase in interest rates typically causes the value of fixed income securities to fall. Changes in interest rates will affect the value of longer-term fixed income securities more than shorter-term securities.

Fixed income securities are subject to credit risk where an issuer may not be able to meet interest or principal payments.

REITs are sensitive to changes in real estate values, property taxes, interest rates, cash flow of underlying real estate assets, occupancy rates, government regulations as well as the management skill and creditworthiness of the issuer.

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