



Fake Diversification Exposed: Does Asset Allocation Work?

David B. Loeper, CIMA®, CIMC®

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When the market closed on June 29, 2010, domestic equities were down 14.5% from their April 23rd high — a formidable decline. Many advisors tout sophisticated (and very expensive) asset diversification strategies, supposedly to protect their clients against precisely these circumstances.



So, with this recent decline, did all of these supposed diversifiers, like foreign and emerging market stocks, real estate, corporate and high-yield bonds (junk), foreign bonds, inflation-protected bonds, commodities, etc., protect portfolios?

Not exactly. The table below shows the price-only return (excluding dividends and interest) from the April 23, 2010 market high through the June 29 market close for a variety of ETFs and other funds that claim to be such diversifiers.

	Price Return (excludes dividends/interest) 4/23/10 - 6/29/10
IShares Barclays 7-10 Year Treasuries (IEF)	7.26%
Vanguard Total Domestic Equity (VTI)	-14.52%
Vanguard World Equity Ex-US (VEU)	-14.28%
IShares Treasury Inflation Protected ETF (TIP)	2.97%
IShares iBoxx \$ Investment Grade Corp. Bond Index Fund (LQD)	2.49%
IShares iBoxx High Yield Corp. Bond Index Fund (HYG)	-3.65%
IShares S&P/Citigroup Int'l Treasury Bond Index Fund (IGOV)	-3.30%
VALIC Company I Intl Govt Bond (VCIFX)	0.00%



IShares JP Morgan USD Emerging Mkt. Bond Index Fund (EMB)	-0.02%
IShares MSCI EAFE Index Fund (EFA)	-17.06%
IShares MSCI Emerging Markets Index Fund (EEM)	-12.75%
IShares Dow Jones U.S. Real Estate Index Fund (IYR)	-10.41%
IShares FTSE EPRA/REIT Developed Real Estate ex U.S. (IFGL)	-12.90%
IShares S&P GSCI Commodity-Indexed Trust (GSG)	-13.34%
IShares COMEX Gold Trust (IAU)	7.24%

Hmmm... funny — the only things you could add to your portfolio to *materially* dampen the recent market's decline were 7-10-year Treasury bonds and gold. But gold doesn't pay any interest, costs money just to hold, and has a 200-year real return of 0%, according to Jeremy Siegel in his book *Stocks for the Long Run*.

Last fall, when I took over the management of a \$25 million portfolio for a non-profit, they were very concerned about our 50% allocation to IEF, the 7-to-10 year Treasury ETF. After all, "everyone knew" that interest rates were going to rise (the 10-year Treasury was yielding around 3.5% at the time). Indeed, when the market rallied earlier this year, the 10-year yield rose to almost 4%. That hurt Treasury bonds, but stocks were rallying.

Despite "everyone knowing" interest rates going to rise, here we sit today with the 10-year yielding 2.97%, and its appreciation buffered about half of the market's decline. Not a bad diversifier for its 15 basis point expense ratio. The non-profit investment committee got more comfortable with owning Treasury bonds of this maturity when I showed them the worst twelve month return for them going back to 1926 was a decline of less than 10%. Contrast that track record with other diversifiers'.

You would think people would learn

What about the really devastating markets of 2008? The differences there were even more extreme.



	Price Return (excludes dividends/interest) 2008
IShares Barclays 7-10 Year Treasuries (IEF)	15.99%
Vanguard Total Domestic Equity (VTI)	-36.99%
Vanguard World Equity Ex-US (VEU)	-43.43%
IShares Treasury Inflation Protected ETF (TIP)	-2.05%
IShares iBoxx \$ Investment Grade Corp. Bond Index Fund (LQD)	0.11%
IShares iBoxx High Yield Corp. Bond Index Fund (HYG)	-17.56%
IShares S&P/Citigroup Int'l Treasury Bond Index Fund (IGOV)	N/A
VALIC Company I Intl Govt Bond (VCIFX)	-0.55%
IShares JP Morgan USD Emerging Mkt. Bond Index Fund (EMB)	-4.30%
IShares MSCI EAFE Index Fund (EFA)	-42.13%
IShares MSCI Emerging Markets Index Fund (EEM)	-49.47%
IShares Dow Jones U.S. Real Estate Index Fund (IYR)	-40.54%
IShares FTSE EPRA/REIT Developed Real Estate ex U.S. (IFGL)	-52.10%
IShares S&P GSCI Commodity-Indexed Trust (GSG)	-45.75%
IShares COMEX Gold Trust (IAU)	5.22%

(IGOV wasn't available in 2008 which is why I included the Valic International Government Fund.)

Unlike the recent decline, during which some of the expensive "diversifiers" actually did help a tiny bit, most of them made the performance even worse in 2008 ... the exact opposite of what they were supposed to do. Those inexpensive Treasury bonds, on the other hand, protected capital as they should, even tripling the return of gold.

Here's the scam: The basic asset allocation theory that caught on was based on some long-term data that showed the value of blending stocks, bonds and cash. In fact, the Brinson, Hood and Beebower study held in high esteem by advisors demonstrated that more than 90% of the variance in returns among large pension plans was explained



merely by their allocation to stocks, bonds and cash. In other words, less than 10% of variation was explained by all these expensive so-called diversifiers. But advisors can charge more if their pie charts look more complicated, touting the supposed value of "non-correlating assets" that tend to correlate a lot when you need them not to the most.

Advisors have a conflict of interest in this game — they have an incentive to make things far more complicated than is necessary to justify higher fees. Moreover, their friends who manage the expensive products get to charge a lot more in management fees. Even low-fee Vanguard charges more than three times the management fee for their World Equity Ex-US ETF (VEU, 25 basis points) versus their Total Domestic Equity ETF (VTI, 7 basis points). And check out the *huge* weighting semi-passive fund company DFA suggests for their expensive real estate and foreign funds where they earn double or more the fees of other funds they manage. The product vendors and research departments fool advisors to get more product fees, and advisors in turn often unwittingly end up fooling their clients. But, as we've seen with Treasury bonds: To achieve diversification, you don't need to spend a lot of money.

I'm in no way implying that I know where markets are going. They are *always* uncertain, and if anyone tells you otherwise, he is either lying to you or lying to himself, if not (in reality) both. I'm also not even remotely inferring that past performance is indicative of future results. If the economy gets stronger, it is likely that interest rates will rise and bonds will suffer, but odds are stocks would take that as pretty good news, providing the uncorrelated performance investors desire.

We all need diversification to protect our portfolios from market shocks, recessions and depressions. Treasury bonds have done well during declines similar to this spring's, the decline of 2008, the 1987 Crash and even the Great Depression. I cannot guarantee they will do it again, but when the markets get scared, Treasury bonds have been the consistent beneficiary of the ensuing flights to safety.

A popular industry speaker and writer, David B. Loeper is the CEO and founder of Financeware, Inc. in Richmond, VA. He is author of the top-selling book [Stop the 401\(k\) Rip-off!](#), three other books released in 2009 by John Wiley & Sons ([Stop the Retirement Rip-off](#), [Stop the Investing Rip-off](#) and [The Four Pillars of Retirement Plans](#)) and numerous white papers. You may [subscribe](#) to our educational emails.

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