ADVISOR PERSPECTIVES

Diversification- When More is Less

By David B. Loeper, CIMA®, CIMC®
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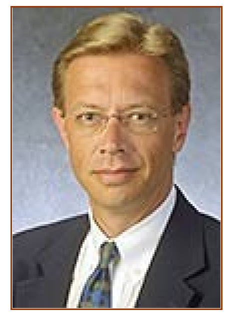
"Do not be fooled into believing that because a man is rich he is necessarily smart. There is ample proof to the contrary." - **Julius Rosenwald**



So how is all that "diversification" that various financial product marketers and asset allocation academics have been pitching for years working out for you?

Hedge funds were supposed to be non-correlated and used to "reduce portfolio risk," but over the last year they are down 17-24%. Equity REITs and REIT mortgages were supposed to be a diversifier, but they are down 37% plus. Foreign stocks and emerging markets were supposed to diversify away some of the equity market risk exposure, but they are down 46-56% respectively. TIPs and high yield bonds were supposed to help "diversify" fixed income allocations, yet relative to plain garden variety intermediate government bonds they have underperformed by 18-27% respectively. Commodities were another "asset class" tossed into the theoretical diversification bucket, but they are down 26%.

Many in the industry raised shrill and unpleasant complaints when I criticized the bromides product marketers used to push these expensive and so-called diversified alternatives. To them I simply say, "I told you so."

All of these asset classes (a term used very loosely by the expensive product purveyors) were supposedly going to protect you by lowering portfolio risk, which would justify the high expenses. Also, the *theoretically* more diversified allocation strategy was not only going to "lower" portfolio volatility but was supposed to enhance your compound investment return to boot.

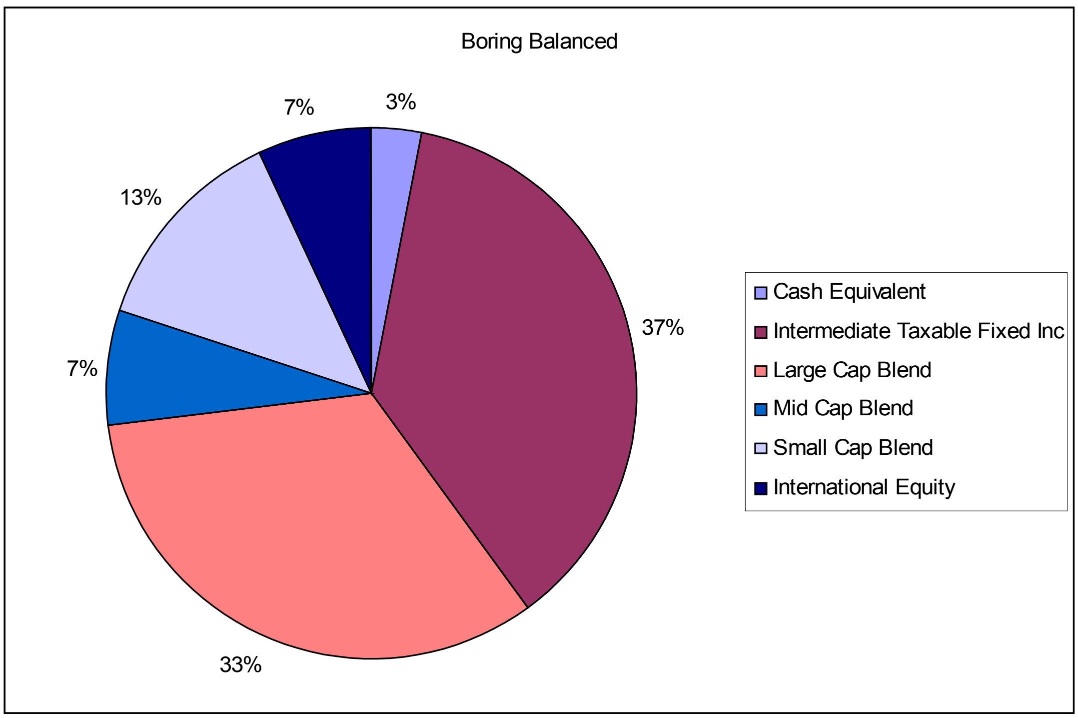
The price of bogus diversification

Pretty pie charts with numerous multi-color slices have enchanted both investors and advisors alike. But simple allocation models, based on the main drivers of the variance in portfolio returns (stocks, bonds and cash per Brinson, Hood and Beebower[i]) *appeared* to be too easy to create, and less diversified. Also, such simple portfolios were very inexpensive to assemble from ETFs (weighted average expense ratio of about 0.16%) which meant that massive product fees were impossible to justify without the added mystery of other “sophisticated” assets.

The “Broadly” diversified balanced portfolio with more risk than equities

A simple and low cost balanced ETF portfolio allocation, based on generic indices* would be down about 21.5% for the year ending 11/30/2008 (actual results can be a little better, depending on the ETFs used). The pie chart for the allocation is unimpressive and visually even looks less diversified than a “more sophisticated” allocation strategy (See Figure 1).

Figure 1- Boring balanced portfolio allocation down about 21.5% for the year ending 11/30/2008



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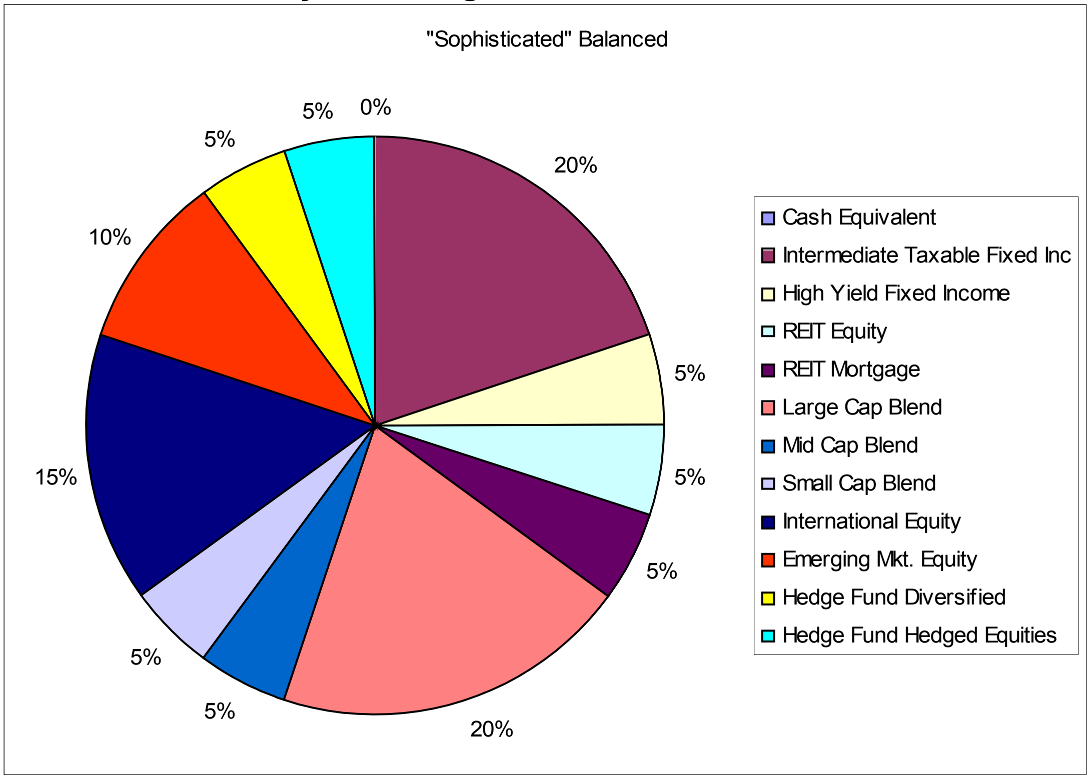
But look at how beautifully colorful the more sophisticated and "more" diversified balanced portfolio offered by the "sophisticated" product purveyors and asset allocation academics is…clearly it would have less risk! Just look at all of those pie slices! (See Figure 2)

Figure 2- "More" diversified "sophisticated" balanced portfolio allocation, DOWN 40% for the year ending 11/30/2008



Wait a minute! With all of those extra slices, with all of that "extra" diversification, HOW can this sophisticated balanced portfolio be down ***more*** than total domestic equities??? Wasn't this balanced allocation supposed to reduce my risk? And, how can a basic 60/40 stock/bond portfolio outperform this more sophisticated and *theoretically* more diversified portfolio by 19% over the last year?

As explained in the first paragraph, asset class diversification as is currently applied with false conventional wisdom failed in this environment, just when investors needed it the most.

Some might consider the current market environment to be an "outlier"…a Black Swan if you will. Besides, prior to this outlier market, this sophisticated allocation produced high risk adjusted returns. Then again, that was *in the past*. Prior to this outlier event, this allocation might have outperformed by 2% over the last ten years. Even over the last thirty years it might have outperformed by 1%. Well, you had better hope that happens in the future because you NEED it to be right for the next 15 to 30 years just to make up for the risk of this supposedly more diversified, sophisticated portfolio (see Figure 3).

Figure 3 – Boring balanced portfolio growth of $100, AFTER the last year's losses versus a "sophisticated" balanced portfolio and how long it will take to make up for the risk just experienced with 1% out-performance and 2% out-performance for the next 15-30 years:

Assumed Return:	*8.00%* Boring Balanced	*9.00%* Sophisticated	*10.00%* Sophisticated
Starting Value of $100 after the last year	**$ 78.52**	**$ 59.83**	**$ 59.83**
Year 1	$ 84.80	$ 65.21	$ 65.81
Year 2	$ 91.58	$ 71.08	$ 72.39
Year 3	$ 98.91	$ 77.48	$ 79.63
Year 4	$ 106.82	$ 84.45	$ 87.59
Year 5	$ 115.37	$ 92.05	$ 96.35
Year 6	$ 124.60	$ 100.33	$ 105.99
Year 7	$ 134.56	$ 109.36	$ 116.58
Year 8	$ 145.33	$ 119.21	$ 128.24
Year 9	$ 156.95	$ 129.94	$ 141.07
Year 10	$ 169.51	$ 141.63	$ 155.17
Year 11	$ 183.07	$ 154.38	$ 170.69
Year 12	$ 197.72	$ 168.27	$ 187.76
Year 13	$ 213.54	$ 183.42	$ 206.54
Year 14	$ 230.62	$ 199.92	$ 227.19
Year 15	**$ 249.07**	**$ 217.92**	**$ 249.91**
Year 16	$ 268.99	$ 237.53	
Year 17	$ 290.51	$ 258.91	
Year 18	$ 313.75	$ 282.21	
Year 19	$ 338.85	$ 307.61	
Year 20	$ 365.96	$ 335.29	
Year 21	$ 395.24	$ 365.47	
Year 22	$ 426.86	$ 398.36	
Year 23	$ 461.01	$ 434.21	
Year 24	$ 497.89	$ 473.29	
Year 25	$ 537.72	$ 515.89	
Year 26	$ 580.74	$ 562.32	
Year 27	$ 627.20	$ 612.93	
Year 28	$ 677.37	$ 668.09	
Year 29	$ 731.56	$ 728.22	
Year 30	**$ 790.09**	**$ 793.76**	

Figure 3 shows you that if you started a year ago with $100 invested in the boring balanced allocation, a year later it would be worth $78.52. The "sophisticated" balanced allocation would have declined to $59.83. If one assumes an 8% return for the boring balanced allocation going forward, how long will it take to make up for the risk experienced over the last year with the sophisticated allocation if it outperforms by 1% (a 9% assumed return)? Maybe that sophisticated allocation will out perform by 2% (a 10% assumed return) and if it does, it will take fifteen years to make up for the risk just experienced.

Can your allocation outperform by 2% a year, net of all the extra expenses? It had better do so for the next 15 years to make up for the risk you just experienced. If it only adds 1%, you better hope there isn't another devastating market anytime in the next 30 years because it will take you another 30 years to make it up.

Of course, in real wealth management plans, there are cash flows like savings and retirement income, which is what *we* manage. Subjecting clients to the asset allocation bets like the balanced allocation shown in Figure 2 is a risk real wealth managers avoid because wealth management plans with cash flows cannot afford to make such gambles of whether the money will be there when needed.

Simple and low cost is a safer route than expensive and theoretically sophisticated. Jettison the sizzle and focus on goals. Avoiding needless risk lets you make the most of your life and your clients' lives.

*Indices used:

Cash Equivalent	CRSP Index: 3 Month T-Bill.
Intermediate Taxable Fixed Inc	BarCap US Govt/Credit Interm TR USD (%Total Return)
High Yield Fixed Income	ML US High Yield, Cash Pay.
REIT Equity	FTSE NAREIT Equity REIT Index.
REIT Mortgage	FTSE NAREIT Mortgage REIT Index.
Large Cap Blend	S&P 500
Mid Cap Blend	Morningstar Mid Cap 400
Small Cap Blend	Morningstar Small Cap 600
International Equity	MSCI EAFE Index
Emerging Market Equity	MSCI Emerging Market Index
Commodities	Goldman Sachs Commodity Total Return Index
Hedge Fund Diversified	Hedge Fund Research Inc (HFRI) Diversified Index.
Hedge Fund Hedged Equities	Hedge Fund Research Inc (HFRI) Hedged Equity Index.

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[i1] Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, *Determinants of Portfolio Performance*, The Financial Analysts Journal, July/August 1986 and *Determinants of Portfolio Performance II: An Update*, The Financial Analysts Journal, (1991)

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 being 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 whitepapers. He has appeared on CNBC and Bloomberg TV, served on the Investment Advisory Committee of the $30 billion Virginia Retirement System, and was chairman of the Advisory Council for the Investment Management Consultants Association (IMCA). Before founding Financeware in 1999 he was Managing Director of Strategic Planning for Wheat First Union. He earned the CIMA® designation (Certified Investment Management Analyst) from Wharton Business School in 1990 in conjunction with IMCA.