



Letters to the Editor Diversification - When More is Less

December 23, 2008

The letters below are in response to the article last week [Diversification – When More is Less](#), by David Loeper. Following these letters is a response from Mr. Loeper.

Dear Editor:

Mr. Loeper should be commended for his advocacy of lower expenses and portfolio simplification, but there are two problems with his analysis.

First, his hypothetical portfolios are constructed in such a way as to compare apples to oranges. In the "Boring" portfolio, there's an allocation of 40% to risk free or low risk assets (intermediate taxable income and cash), while in the "Sophisticated" portfolio, this appears to have been ratcheted down to a weight of 20%. In other words, as the allocation to risky assets is increased by 33% (from 60% in the Boring portfolio to 80% in the Sophisticated portfolio), the implication is that those parties recommending sophisticated allocations would subsume the cash flow component of "wealth management plans with cash flows" to gambles on (slightly) higher returns. Has this been a standard practice among planners, and if so, can it be documented? If not, then the weight of risky assets should be equal in the two portfolios before drawing any conclusions about recent, historical, or future returns.

Second, although he mentions risk-adjusted returns, his data leaves out portfolio volatility, when the primary objective of most "asset allocation academics" is to minimize the risk assumed per unit of desired return. A better analysis would tell us whether, given a particular level of net return (thus accounting for the negative impact of fees and expenses), the sophisticated portfolio offers a significantly lower level of volatility than the boring one (it would also be helpful to know how investment cash flows were accounted for in his performance data). Furthermore, as the old economic adage goes, sunk costs are sunk costs. The proper focus of a portfolio allocation today is not whether it can recover past losses, but rather what kind of lifestyle it can support in the future, and at what risk.

Lower cost and simplification are desirable goals in portfolio design, and this topic is worthy of further study. I would be interested in seeing how well Mr. Loeper's conclusions hold up once the foregoing adjustments are made.



Art Patten
President
Symmetry Capital Management, LLC
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Dear Editor:

David's article presents an unfair comparison. He compares two portfolios ("boring" and "sophisticated") that have dramatically different cash and fixed income exposures.

His boring portfolio has 3% cash and 37% intermediate bonds, while his sophisticated portfolio has 0% cash and 20% intermediate bonds.

Is it any wonder that in 2008 the boring portfolio performed better? Fixed income and cash are the only survivors (other than inverse funds and some hedge funds).

He is comparing apples to concrete.

Regards,

Craig L. Israelsen, Ph.D.
Brigham Young University

Dear Editor:

I know Dave Loeper and his analysis follows the old saying "there are lies, damn lies and then there are statistics." I would have like to have seen these portfolios starting in 1/1/2002; then you would have seen the performance differential of the more diversified portfolio. Although it under-performed in 2008, it provided a substantial cushion and therefore the clients' portfolios would have a similar ending value or starting value for the next set of analysis, which is the catch-up chart.

The problem with Monday morning quarterback analysis is the markets are discounting forward mechanisms and not rational backward looking mechanisms. If you owned only investments below the valuation trend line in 2007, you would



be in TIPS all year and would have out performed Loeper's simple allocation by 23%. Over the next 30 years, I am pretty sure 100% in TIPS is probably not the best strategy, but it will benefit from the strong inflationary period we will soon enter. Nonetheless, I will bet on emerging markets over TIPS if my time horizon is 30 years because TIPS are expensive and emerging markets are cheap.

Anonymous

Here is the response from Dave Loeper:

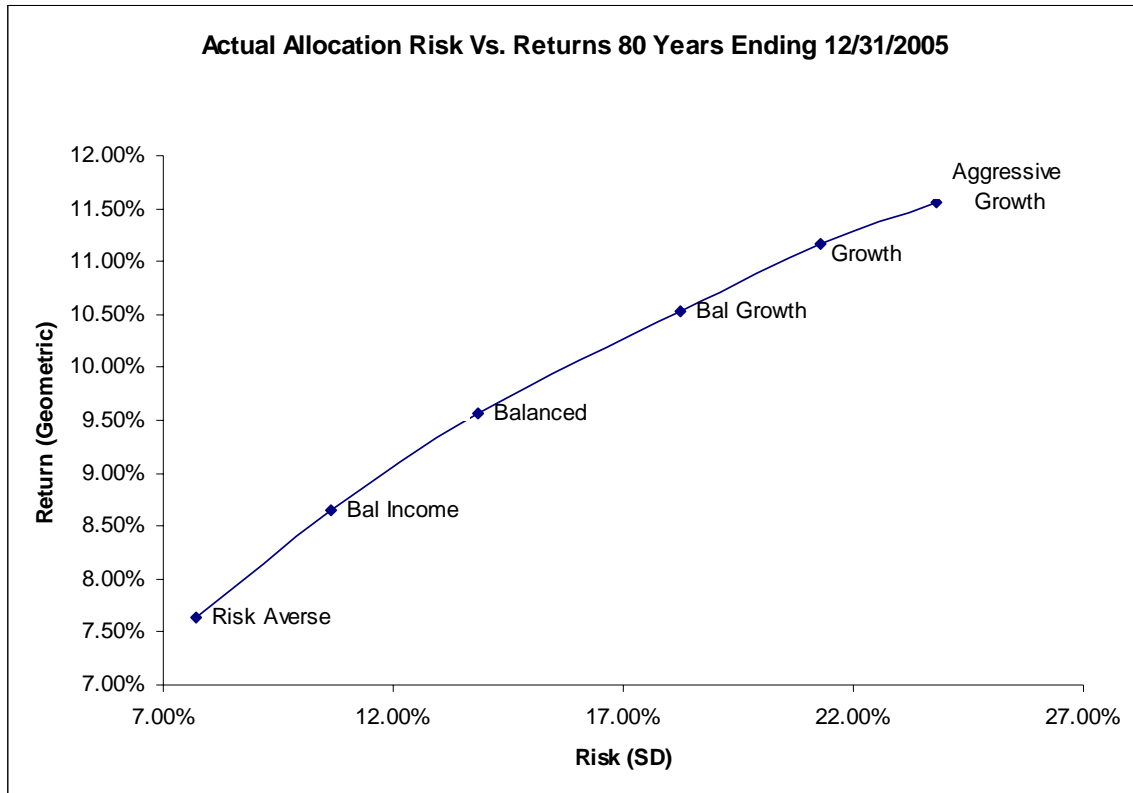
Let us deal with these questions one at a time. Art Patten asked whether the sophisticated portfolio approach was standard practice among planners and if that could be documented as such. There is a simple answer to that and it is NO. Not all advisors have succumbed to the sales spin, and some remain skeptical of product purveyors pitches. I'd like to point out though that the original article was not meant to represent "standard practice" across all advisors. It was merely representative of the portfolio decisions I have debated over the last decade with numerous advisors when I attempted to warn them about the non-systematic risk they were constructing in their portfolios.

As for Mr. Patten's argument that I am comparing apples to oranges, because apparently he doesn't put REITS, High Yield, and Hedge funds into the low risk diversifier category as they are often sold, I say fine, pick a better benchmark because of the exposure to risky assets. Our 80% equity allocation model (known as balanced growth) would have been down 29% over the same period the "sophisticated" portfolio was down 40%. To make THAT an "apples-to-apples" comparison, REIT mortgages be classified as equity, as would high yield bonds. Diversified hedge funds would also have equity risks and returns, as would hedged equity hedge funds. Personally, I would treat all of these assets to be more equity-like, to more accurately model the nature of these assets. The bets on them still had them contributing to a 40% loss versus a 29% loss in a boring portfolio with 80% equity exposure.

Finally, his assertion that the more sophisticated portfolio would produce lower volatility or higher return is undocumented. Produce the evidence. Figure 1 shows an eighty year risk-versus-return chart for our model allocations that we have used for a decade. Please provide the data to support your claim.



Figure 1- Stock, Bonds and Cash, Decade old allocation models:



Next, in response to Craig, 3% cash isn't going to make up for a 20% additional decline. Compare the sophisticated allocation to our balanced growth model allocation that is 80% equity. The "sophisticated" allocation still declined by an additional 11%, without comparing apples to concrete. I'm sure that few advisors ever pitch hedged equities, or "diversified" hedge funds, high yield bonds, and mortgage REITS as anything other than equities...to make this an apples-to-apples in comparison.

Finally, to the anonymous writer questioning what the cushion of out-performance would have been since 1/2002, I suggest he or she do the homework and calculate it. I can say that over that period, the cushion would have needed to have been about 4% A YEAR superior performance in the 2002-2007 time frame to make up for the non-systematic risk the "sophisticated" allocation experienced exposed over the last year.

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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.

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