# Not a Lost Decade for Diversified, Balanced Portfolios

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In absolute terms, the past decade was the worst in modern stock market history, with two substantial bear markets (2000-2002, and 2007-2009) and the S&P 500 Index returning a cumulative -9.1%. No wonder the *Wall Street Journal's* David Weidner called it the "Lost Decade of Stock Investing."

Pundits have taken advantage of these dismal returns to challenge long-held investing principles. In February, Bank Investment Consultant writer Joan Warner declared that the "classical approach to asset management has let an entire generation down." And she's not alone. In a *Barron's* article written a year ago, author Mike Hogan asserted that "markets are likely to be too erratic in the future to rely only on nicely structured portfolios and economic growth."

Did the last ten years really demolish the foundations of Modern Portfolio Theory and classic investing principles? How did portfolios that stuck to the principles of effective diversification and buy-and-hold investing actually perform during the so-called "Lost Decade?"

A negative return for U.S. equities is a historically rare event. Between January 1926 and December 2009, fully 95 percent of the possible rolling ten-year investment windows delivered positive returns. Only five percent of the time would money invested for a ten-year period fail to produce gains.

In addition, once you look beyond U.S. large-cap equities and the recent gloom and doom on Wall Street, conditions really weren't too bad for stock investing. As the chart below shows, most equity asset classes generated positive returns over the course of the decade, despite lost ground in the S&P 500 Index and a cumulative decline of 33.4 percent among U.S. large growth stocks (as measured by the Russell 1000 Growth Index).

U.S. Value, U.S. Small, International Value, and International Small equity asset classes all delivered a positive return for the decade. And REITs and Emerging Markets generated quite appealing returns.

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## U.S. and International Equity Market Indexes

Annualized Returns through December 31, 2009

| | Ten Years (annualized) % | Ten Years (cumulative) % |
|---|---|---|
| S&P 500 Index | -1.0 | -9.1 |
| Dow Jones US Total Stock Market Index | -0.2 | -1.7 |
| Russell 1000 Value Index | 2.5 | 27.6 |
| Russell 1000 Growth Index | -4.0 | -33.4 |
| Russell 2000 Index | 3.5 | 41.2 |
| Dow Jones US Select REIT Index | 10.7 | 175.6 |
| MSCI EAFE Index | 1.2 | 12.4 |
| MSCI World Ex. US Value Index | 4.1 | 48.7 |
| MSCI World Ex. US Small Cap Index | 6.9 | 94.9 |
| MSCI Emerging Markets Index | 9.8 | 154.3 |
| Merrill Lynch Treasury/Agency 1 to 5 Year Index | 5.1 | 64.3 |

*Data Sources: S&P 500 Index data are provided by Standard & Poor's Index Services Group, Russell Index data provided by The Russell Company, www.russell.com; MSCI Index data provided by Morgan Stanley Capital International Group Inc. www.mscibarra.com (January 2010). Indexes are unmanaged baskets of securities in which investors cannot directly invest. Actual investment results may vary. All investments involve risk, including loss of principal. Past performance is not indicative of future results. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting.*

While the index comparisons look good on paper, it is more useful to examine a hypothetical model portfolio that follows the disciplines of diversification and long-term investing, so I'll use an example from my own firm, Loring Ward.

We base our portfolio-modeling approach on principles of diversification, asset class investing, and on Prudent Investor Rule guidelines. The process also applies Fama-French research and multi-factor modeling to emphasize value and small cap asset classes in both U.S. and International markets. By constructing a broadly diversified global "market" portfolio and emphasizing value and small cap asset classes, the models attempt to maximize investment return while minimizing portfolio volatility.

Our Global Equity and Global Moderate portfolios use Dimensional Fund Advisor (DFA) mutual funds that track the market indexes listed in the previous chart. Our Global Equity portfolio produced a cumulative return of 58.3% for the past decade by diversifying broadly by dividing investments among U.S. and international value and small cap equities. Its division between asset classes was as follows:

*DFA International Value Portfolio – 26%;DFA US Large Company Portfolio – 21%; DFA US Large Cap Value Portfolio – 18%; DFA US Small Cap Portfolio – 15%;*

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*DFA International Small Company Portfolio – 10%; DFA Real Estate Securities Portfolio – 5%;*
*DFA Emerging Markets Portfolio – 4%; Cash – 1%.*

**Structured Investing Portfolios**
Annualized Returns through December 31, 2009

| Allocation | Portfolio | Ten-Year Total Return | Ten-Year Risk* |
|---|---|---|---|
| 98% Equity / 2% Bonds | Global Equity Portfolio | 58.3% | 17.9% |
| 65% Equity / 35% Bonds | Global Moderate Portfolio | 69.7% | 11.8% |
| | S&P 500 Index | -9.1% | 16.2% |

*Structured Investing Global Equity and Moderate Portfolios are based on Loring Ward portfolio allocation models with investments in recommended DFA mutual funds for each asset class. The Global Equity Portfolio is DFA International Value Portfolio – 26%;DFA US Large Company Portfolio – 21%; DFA US Large Cap Value Portfolio – 18%; DFA US Small Cap Portfolio – 15%; DFA International Small Company Portfolio – 10%; DFA Real Estate Securities Portfolio – 5%; DFA Emerging Markets Portfolio – 4%;Cash – 1%; The Global Moderate Portfolio is DFA Five-Year Global Fixed Income Portfolio - 16%;LWAS/DFA Two-Year Government Portfolio - 16%; DFA International Value Portfolio - 16%; DFA US Large Company Portfolio - 14%; DFA US Large Cap Value Portfolio - 12%; DFA US Small Cap Portfolio - 10%; DFA International Small Company Portfolio - 7%; DFA Real Estate Securities Portfolio - 4%; DFA Emerging Markets Portfolio - 3%;Cash - 2%. Cash allocation is 30-Day Treasury Bill Index. Portfolio returns are the weighted average returns of the respective funds, rebalanced annually. Actual rebalancing may be different. The portfolio allocations are based on a hypothetical model portfolio, which may not be suitable for all investors. It may not reflect the impact material economic and market factors might have had on decision making if clients' money were actually being managed at that time. Assumes dividend and capital gain reinvestment. Portfolio returns reflected above are after 1% annual advisory fees and funds' internal expenses. The performance quoted represents past performance. Past performance does not guarantee future results. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original costs. Current performance may be lower or higher than the performance data quoted. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Small company stocks may be subject to a higher degree of market risk because they tend to be more volatile and less liquid. The S&P 500 Index is a market capitalization weighted index that includes 500 leading companies in leading industries of the U.S. economy. Investors should consider the investment objectives, risks, charges and expenses of the funds before investing. This information can be found in the prospectus. Before investing in any fund, please carefully read the prospectus. To obtain performance information current to the most recent month-end, please see your Advisor. Fund net expense ratios are as follows: DFA US Large Company, 0.15%; DFA US Large Cap Value, 0.28%; DFA US Small Cap, 0.38%; DFA International Value, 0.44%; DFA International Small Company, 0.55%; DFA Real Estate Securities, 0.33%; DFA Emerging Markets, 0.60%.*
**To obtain a prospectus, please call 1-800-366-7266.*

In keeping with our investing philosophy, we use fixed income assets as a brake, not a throttle, to stabilize overall portfolio returns across volatile markets. This strategy proved particularly valuable during the last decade's two bear markets. In both cases, the high-quality fixed income performed as expected and helped to protect the portfolio from extreme losses.

Not surprisingly, considering the last ten years' volatility, our portfolio that invested a higher portion in fixed income did even better. Our Global Moderate Portfolio, a diversified strategy with 35% allocated to high-quality fixed income, delivered cumulative returns of 69.7% with significantly lower volatility than the S&P 500 Index (based on the standard deviation of 11.8% vs. 16.2%).

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The Global Moderate Portfolio was divided among asset classes in this way:

*DFA Five-Year Global Fixed Income Portfolio - 16%;*
*LWAS/DFA Two-Year Government Portfolio - 16%;*
*DFA International Value Portfolio - 16%; DFA US Large Company Portfolio - 14%;*
*DFA US Large Cap Value Portfolio - 12%; DFA US Small Cap Portfolio - 10%;*
*DFA International Small Company Portfolio - 7%; DFA Real Estate Securities Portfolio - 4%;*
*DFA Emerging Markets Portfolio - 3%;Cash - 2%.*
*Cash allocation is 30-Day Treasury Bill Index*

These model portfolios and allocations were in place on January 1, 2000. We made minor changes to the models in early 2007, primarily to add the emerging markets and REITs asset classes, which the models had not previously incorporated. The basic allocation ratios of fixed vs. equity, U.S. vs. International equity, and small and value equity, however, were consistent throughout the decade. The models assume annual rebalancing to maintain the ratios.

I'll be the first to note that past performance is no guarantee of future results. That said, these portfolios show that the core principles of Modern Portfolio Theory worked just fine during the "Lost Decade."

You can use examples like these diversified portfolios and their long-term performance during the worst investing decade in modern history to counsel your clients the next time they pressure you to give in to the latest investment fad or succumb to panic. Many investors who diversified and stuck to disciplined, scheduled rebalancing over the last ten years avoided the losses trumpeted by the headlines and made progress towards achieving their long-term investment goals.

*Note: Past performance is not indicative of future results. Diversification does not guarantee a profit or to protect against a loss. The risks associated with investing in stocks and overweighting small company and value stocks potentially include increased volatility (up and down movement in the value of your assets) and loss of principal. Small-cap stocks may be less liquid than large-cap stocks. Foreign securities involve additional risks including foreign currency changes, taxes and different accounting and financial reporting methods All investments involve risk, including loss of principal.*

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