Commentary

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"Is Diversification a Drag?"

Investors tire of hearing that "proper allocation" and "diversifying your portfolio" are the keys to a solid investment plan. It all sounds sort of *jargony*, and –after all- you just want your investments to grow, right? Give me the bottom line, and forget the fancy words. And, if diversification means owning international stocks and various other investments which held you back that last 2 or 3 years, you may be asking, "what's the point?"

- **The Point:** Diversification is *not* used to boost performance or insure against losses, but rather to find a mix that matches your appetite for risk, meshes with your goals, and has the *potential* to optimize returns given your level of risk. It tries to smooth the ride, and *sometimes* better performance may be a happy result.
- **Allocation or Diversification?** Allocation refers to the percentages devoted to general asset classes such as stocks, bonds and cash. Diversification is spreading out your investments within these categories: small company stocks, large company stocks, international stocks, short term bonds, long term bonds, energy, real estate, technology, etc.
- **What's Hot Today May Falter:** Spreading investments among many categories means there will normally be some lagging those which sprint ahead. In 2014 and 2015, big U.S. stocks lead the pack, but that was the only time in the last 15 years. Some of today's laggards will likely be tomorrow's winners, but there's a "near impossibility of picking the best performer ahead of time". (Brad McMillan, Commonwealth Financial Network).
- **When Diversification Looks Stupid:** From 2011-2015, the S&P 500 Index* averaged a 13% annual return; whereas a model of 60% stock/40% fixed income (S&P 500, Barclay's Aggregate Bond) averaged just over 6%. A diversified allocation will almost always lag a 100% stock index in a bull market.
- **When Diversifying Makes You a Genius:** Historically, pretty much any time there have been recessions, corrections, and bear markets. What a diversified portfolio has been able to do, (historically speaking) is to contain/mitigate portfolio losses during big downturns. And . . . recessions, bear markets, and corrections are sure to pop up periodically along our financial paths, as they have been for the last 150 years.
- **Case in Point for Mixing it Up:** Had you invested $500,000 in a moderate, diversified mix (proxy is the DJ Moderate Portfolio**) in January 2000, you'd have $1.21 million today; had you invested it in the S&P 500, you'd have *$248,000 less* ($961,700). The main reason is that from 2000-2002 you'd have been down -38% versus -12% for the moderate model. In 2008, down -37% with the S&P 500, and

-24.75% in the model (Morningstar hypothetical). *The hypothetical examples found above are for illustrative and informational purposes only. No specific investments were used in the examples. Actual results will vary and are subject to change.*

- **When Not Diversifying Hurts:** Again, from 2000 to the present, starting with $500,000 and withdrawing $3,000/month (increasing by 2% annually) . . . you'd have withdrawn $687,500 through April, 2016 in the moderate model, and would have $48,000 left today. Investing in the S&P 500, you'd have withdrawn $427,500 and then run out of money at the end of 2010. Yes, you'd have run out of money over 5 years ago (Morningstar hypothetical).
- **Crazy Math:** Too much volatility can hurt performance, and reducing volatility is a goal of diversification. It's the reason two portfolios with the same *average* return can have very different ending values. How can that be? Take portfolio A (aggressive), starting with $100,000 and returns over three years of -50%, +50%, +30% . . . that's an average return of 10%, and the ending value is $97,500. Portfolio B is less volatile and has returns of -25%, +30%, +25% -an average of 10%- and has and ending balance of $121,875!
- **Big Gains = Big Pains:** Eventually. An investing axiom is "to get higher returns, you must take more risk". That 13% annual average return of the S&P 2011 -2015 came with a risk that was 50% higher than a diversified asset allocation model (Morningstar). That's the same S&P 500 that dropped 50% in 2008. Having lived through that, would you have the stomach to gut it out a second time? Diversifying has historically helped smooth the ride by optimizing the level of risk based on your goals and risk "appetite". Smooth is good.

We understand your disappointment when you lag the stock market. You hear terms like diversification, volatility, rebalancing, and correlation and you're looking at a portfolio that seems stuck in neutral. But, you know something? We want you to make money too and we want you to achieve your goals, but we don't want you to fall into a hole you can't get out of. This stuff works, but it demands patience and discipline, and sometimes it isn't easy.

*Diversification does not assure a profit or protect against loss in declining markets, and diversification cannot guarantee that any objective or goal will be achieved. *The S&P 500 Index is unmanaged, and investors cannot actually invest directly into this index. Unlike investments, indices do not incur management fees, charges or expenses. Past performance does not guarantee future results.**The Down Jones Moderate Trust is a risk-based index consisting of stocks, bonds, and cash and is intended to represent 60% of the risk and return of the 100% Global Portfolio Index.*

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