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Diversification - When More is Less

By David B. Loeper, CIMA®, CIMC®

“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 product sellers 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, in theory the "lower" volatility was supposed to enhance your compound investment return to boot.

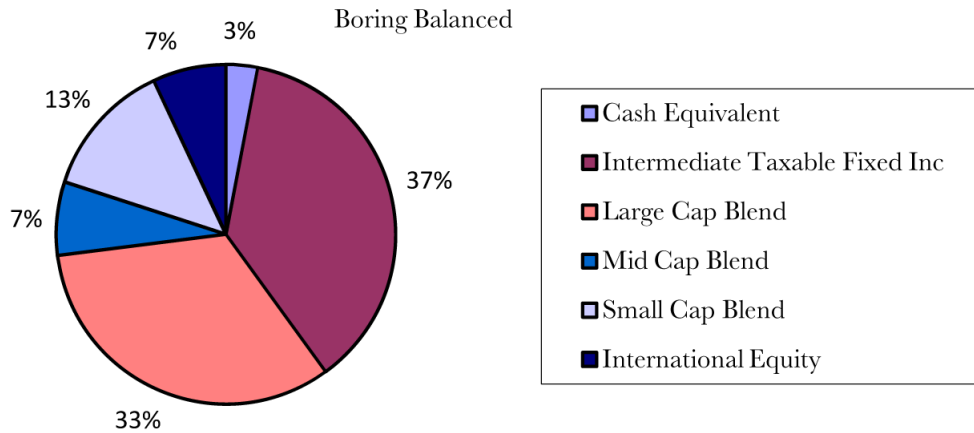
The price of bogus diversification...Now all you need is to outperform by 1-2% every year for the next 15-30 years...just to stay even with a simple balanced portfolio!

Pretty pie charts with numerous multi-color slices have enchanted both investors and advisors alike. Simple allocation models like ours, based on the main drivers of the variance in portfolio returns (stocks, bonds and cash per Brinson, Hood and Beebower¹) 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

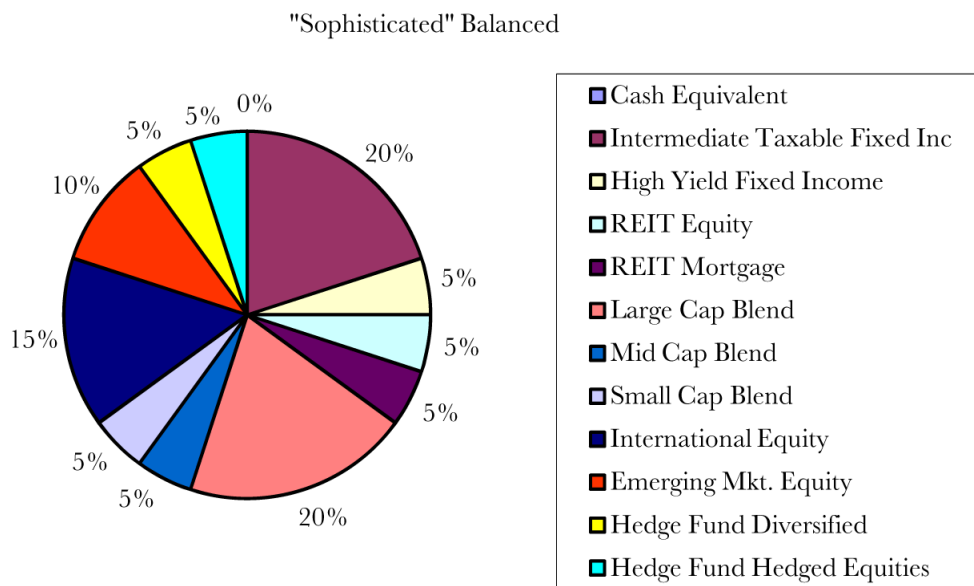
Our simple and low cost balanced ETF portfolio allocation, based on generic indices (see Table 1) would be down about 21.5% for the one year ending 11/30/2008 (actual results are a little better than that for our portfolios, based on the ETFs we use). The pie chart for the allocation is unimpressive 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



But look at how beautifully colorful the more sophisticated and "more" diversified balanced portfolio offered by the "sophisticated" product purveyors is...clearly it would have less risk! (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 equities???. How can a basic 60/40 stock/bond portfolio outperform this more sophisticated and *theoretically* more diversified portfolio by 19% over the last year? (See the first paragraph for the answer.)

Well, the current market environment is an "outlier"...a Black Swan if you will, and after all this sophisticated allocation produced high risk adjusted returns *in the past*. Prior to this outlier event, I might have outperformed with this allocation by 2% over the last ten years. Even over the last thirty years I 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%	9.00%	10.00%
	Boring Balanced	Sophisticated	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	

Think your allocation can out-perform 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 had 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 these risks is something wealth managers would 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. If you are ready for a change to jettison the sizzle and focus on goals, avoiding needless risk and making the most of your life (or your clients' lives), maybe it is time you should contact Wealthcare Capital Management.

Table 1 - Asset classes and their corresponding indices

Asset Class	Index
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

REFERENCES

¹ 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)

ABOUT THE AUTHOR

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.

WEALTHCARE RESOURCES

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- Friday, December 19th, 2008 our support offices will close at 5:00PM
- Wednesday, December 24th, 2008, our support offices will close at 1:00PM
- Thursday, December 25th, 2008, our support offices will be closed
- Thursday, January 1st, 2009, our support offices will be closed

We will resume our normal hours on January 2nd, 2009.

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