Diversification and Rebalancing

Many investors attempt to identify a company, industry or asset class they expect to do well in the near future. This is done by reading the financial media, watching talking heads on TV or looking for an advisor with a compelling vision of the future. Once the sector is identified they purchase investments, typically mutual funds, in that area. Each is purchased separately, and each for the same reason – because each is expected to do well – to go up. This is the method of short-term investors. Unfortunately, this expectation often reduces itself to owning investments that have done well in the recent past. This type of investing is driven by emotions. If you are making a bet on the near term results of a particular market view it is only logical that as evidence comes in that the bet is wrong, fear will be the driving force and cause the investor to rethink the bet. Similarly if an asset class that is not owned is doing very well and your investment method is to own the best asset, then greed will dictate moving to that asset. This was illustrated well during the tech boom in the late nineties. Investors poured money into anything internet related – greedy for huge profits (see our letters of March 1999, December 1999 or June 2000 in the "Quarterly Newsletter" section of our website to see what we were saying during this time). Then when it all crashed they sold out of fear - not wanting to lose their last dollar.

Studies (by Morningstar and Dalbar to name a couple) abound showing the difference between the investment results of mutual funds and the investment results of the investors in the funds. These studies show investors underperforming their own funds by as much as 50% over long periods of time. These results come from the behavioral mistakes caused by the whip sawing discussed above. Buy as they are rising and sell as they are falling. A hard way to make money.

There is an alternative investment method. This is the method of the long-term investor. Rather than a bet on one or two asset classes in hope that they outperform, we believe the investor should own a portfolio of passively managed asset class funds representing all world markets. While all the owned asset classes have a positive expected long-term return the short-term return is unknowable. The investor should expect and anticipate that in any given time period some asset classes will do better than others. A diversified portfolio aims to own the best asset class, the worst asset class and all the others in between in a given time period. The bet is on the capitalist system as a whole, not on anyone's ability to outguess the rest of the market participants. That allows the investor to avoid the emotional trades because that bet will seldom be second guessed.

This diversification must be accompanied by rebalancing. Rebalancing means starting with a specified percentage in each asset class and then bringing the portfolio back to those weights when they exceed a predetermined parameter. Rebalancing requires selling a bit of the asset class which has over-performed and using the money raised to buy a bit of the asset class which has under-performed. This process maintains the diversification and lowers the risk compared to a non-rebalanced portfolio. Behaviorally this is extremely difficult. It requires going against your emotions. Think about the end of 2008 and beginning of 2009 when this strategy required buying more stock (see our letters of January 2009 and April 2009 to see what we were telling our clients during these historic markets). Having a method in place before events like these occur forces you to make decisions in advance and with our help allows you to make non-emotional decisions during market extremes. Using passive mutual funds for each asset class and then rebalancing the portfolio is the key to both increased return and lower risk.

Here are some long-term examples. In neither January 2000 nor January 1976 would an investor have had a reliable way to predict the returns of the specific asset class choices he/she faced, and the range of outcomes of the choices made is startling. If one could know which asset class would do the best, life would be wonderful. But such knowledge is, we believe, impossible. Consider the following compound annual returns for two past time periods: (see next page for data sources.)

Equity Asset Class	January 2000 - December 2009	Value of $100,000 invested for 10 years		January 1976 - December 2009	Value of $100,000 invested for 34 years
U.S. Large Growth	-3.54%	$69,764		10.03%	$2,577,212
U.S. Large Value	-2.57%	$77,103		11.06%	$3,540,919
U.S. Small	5.42%	$169,517		14.13%	$8,952,608
U.S. Small Value	10.11%	$261,943		16.43%	$17,652,448
MS EAFE	1.58%	$116,962		10.79%	$3,261,940
United Kingdom Small	4.04%	$148,556		14.81%	$10,959,104
Japan Small	3.41%	$139,874		11.23%	$3,730,429
Emerging Markets	10.11%	$261,949		10.98%	$3,448,923

A diversified portfolio of the above asset classes rebalanced annually	4.53%	$155,713		13.83%	$8,180,783
The S&P 500	-0.95%	$90,898		11.06%	$3,538,646
The return of the average U.S. mutual fund investor, as given by Morningstar.	1.38%	$114,689		n/a	n/a

$100,000 invested solely in the S&P 500 in January 1976 would have become $3,538,646 by the end of 2009. $100,000 invested in a diversified portfolio, consisting of evenly weighted positions in each of the equity asset classes listed in the first table above, rebalanced annually, would have become $8,180,783. Diversification and re-balancing have raised total return by more than two full percent per year – 11.06% vs. 13.83%. Over a long time that is a lot of dollars. Of course these results are hypothetical and the period of 1976-2009 was one of generally rising stock markets. And as always, past performance is no guarantee of future performance.

Note carefully the following fact: A 13.83% return is higher than all but three of the asset classes composing the portfolio. The apparent need to choose the one single asset class that will “do the best” is in fact not a real need. The time, energy and emotions spent by the short-term investor are wasted. The long-term investor gets to “do well” and enjoy life too.

Data sources:

US Large Growth Fama/French US Large Growth simulated portfolio courtesy Dimensional Fund Advisors
US Large Value Fama/French US Large Value simulated portfolio courtesy Dimensional Fund Advisors
US Small Fama/French US Small simulated portfolio courtesy Dimensional Fund Advisors
US Small Value Fama/French US Small Value simulated portfolio courtesy Dimensional Fund Advisors
MS EAFE Morgan Stanley EAFE Index
United Kingdom Small Dimensional Fund Advisors simulated portfolio courtesy Dimensional Fund Advisors
Japan Small Dimensional Fund Advisors simulated portfolio courtesy Dimensional Fund Advisors
Emerging Markets Morgan Stanley Emerging Markets Index
Please note – these are model portfolio results only. They are not adjusted for any management fees nor do they represent our actual method or results in specific detail.

This data is for purposes of demonstration only. Mutual funds to purchase the asset classes used in the above illustration may not have existed for the entire period of the illustration nor at the present time. Model performance is not actual performance and should not be interpreted as such. Model performance has severe limitations. The results do not portray any effect the markets or other economic data may have had on the investment advisors' decision making. Also, the results are based on a back-tested method. Back testing means results are achieved through the retrospective use of investment models. A back-tested model might well look good based on past data, but not do as well going forward. All model results assume reinvestment of all dividends and mutual fund distributions. No assumptions should be made that such dividends or distributions will be made in the future with respect to actual portfolios. Taxes have not been accounted for in any way. Depending on the type of account(s) they have, clients will be responsible for paying taxes on capital gains due to rebalancing and on distributions from the funds. No attempt has been made in the model to show the effect of taxes. Market and economic conditions that occurred during the time period used for the models may not be representative of future conditions. The purpose of constructing the model is to lengthen the time frame available for looking at results, thus providing a broader view of possible outcomes, but there is no assurance that this purpose has been achieved. Clients' performance can be positive or negative and may differ materially from the model results shown. Past performance is not an indicator of future performance.