



Riding Out the Market

If charts of recent market performance depicted a roller coaster ride rather than trading activity, it would seem as if the domestic and international markets were an amusement park ride that most of us would find neither amusing nor desirable.

Fortunately, as our client, you are not daunted by such diversions. You already are familiar with concepts such as reversion to the mean, staying the course and focusing on your long-term investment objectives. That's why you know exactly how to respond — by not responding — when such seemingly random ups and downs may occur.

Defining Diversity

What exactly is diversification in the context of investing?

Your portfolio is **diversified** if it is built to be — and managed to remain — a blend of **dissimilar** (low-correlated) investments among equities, fixed income and hard assets, as well as among domestic and international risk factors within equities and fixed income.

In addition, your diversified portfolio should be blended appropriately for your unique willingness, ability and need to accept market risk. It's possible to be diversified either way, but these remain critical components when planning for a successful investment experience. Diversifying or spreading your investments among multiple types of dissimilar investments

Still, thinking about volatility and actually experiencing it are two different things. In this issue of *The Educated Investor*, we revisit one of the most important components of portfolio design that helps us withstand the market's ups and downs: **diversification**.

Those who are familiar with our general investment approach are comfortable with the basic tenets of diversification. Nevertheless, we thought it would be helpful to revisit the subject. It's just that critical to your potential success as an investor. Why does diversification remain as important today as ever, particularly in light of the current market? And did you know that there are types of diversification that we advise against? Read on to learn more.

is not directly about maximizing expected returns. It's about taking neither more nor less risk than you need to, depending on what is appropriate for your individual goals. Likewise, **dissimilar** or **low-correlated** is equally vital. The number of holdings alone doesn't count for much (as is described in more detail in "The Dark Side of Diversification").

Author Larry Swedroe likens the diversified portfolio to a winning baseball team:

In baseball, the general manager's job is to put together a team that is well balanced between hitting, fielding, pitching and running speed. ... A general manager succeeds by building a team with diversified strengths. Similarly, individual investors succeed by building and properly managing diversified portfolios.

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Professor Harry Markowitz described the essential relationship between diversification and investment risk in his acceptance of a 1990 Nobel Prize in Economics (along with professors Merton H. Miller and William F. Sharpe):

An investor who knew future returns with certainty would invest in only one security, namely the one with the highest future return. If several securities had the same, highest, future return then the investor would be indifferent between any of these, or any combination of these. In no case would the investor actually prefer a diversified portfolio. But diversification is a common and reasonable investment practice. Why? To reduce uncertainty!

In the next article, we'll discuss in more detail the role that risk plays within diversification. It is entirely possible to have a portfolio that is diversified across a wide range of uncorrelated asset classes or risk profiles. However, if it is diversified in a way that is either overly or insufficiently risky for you, you've not yet achieved your true goal.



Just-Right Diversification

What is the appropriate level of risk within your diversified portfolio? Like Goldilocks' porridge, it's possible to have too much, not enough, or just the right amount of "heat."

You've probably heard us caution against taking on more risk than you can comfortably digest. This has particularly been the case during the long, pleasant growth that most of the riskier asset classes have been experiencing since around 2003. During such times, it's easy to forget how quickly and sometimes severely the markets can turn, and burn the unwary.

Investor risk tolerance may have experienced a bit of a fire drill during last quarter's gyrations. We were delighted to see that the vast majority of our clients recognized the risk for what it was. We've been cautioning all along against abandoning one's carefully designed, diversified portfolio when the markets turned risky. Our clients took that advice and stayed the course with admirable discipline. An educated investor is indeed a powerful one!

We may not have discussed the opposite effect as frequently: building a portfolio that is **too** conservative for your needs. This is a phenomenon that can particularly prey upon those who are in or near retirement, when the ability to take on financial risk typically decreases.

- ▲ With a shorter investment horizon, you may have less ability to simply wait out bear markets when they occur.
- ▲ If you are no longer working, you might not have the same ability to replace or recover from financial losses.
- ▲ You may in general grow less willing to take on risk and to suffer the emotional stress that bear markets can generate.

Thus, it is often advisable to consider reducing the expected risk within your retirement portfolio. However, it is possible to become **too** conservative.

Volatility, as measured by standard deviation, contributes directly to expected risk. It is essentially the degree to which an individual holding and your overall portfolio are likely to vacillate, exposing you and your assets to risk.

It is true that, as broad categories, equities are more volatile than bonds. For example, the standard deviation of the S&P 500 Index is more than twice that of long-term government bonds. Yet, it is also true that retaining a modest amount of this more volatile equity component within an otherwise all-bond portfolio can actually increase expected returns while reducing volatility. The reduced volatility is a result of the **low correlation** between equities and fixed income. Over the long-run, equities and fixed income tend to march out

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of step with one another and thus balance each other out. At the same time, the higher expected returns of equities versus bonds remains to enhance your portfolio's performance.

There are other ways to migrate to a more conservative portfolio, if that is your objective, in an efficient and effective manner. Rather than simply increasing fixed income and decreasing equities, you can reduce exposure to the riskier equity asset classes, such as small-cap and value. Even then, you may choose to reduce rather than eliminate these holdings. The objectives of your portfolio might warrant a more conservative approach, but that doesn't mean it's necessary to wholly abandon allocations to individually

riskier components. Again, even as each component may be individually more or less risky, a careful blending of low-correlated holdings can actually reduce overall volatility.

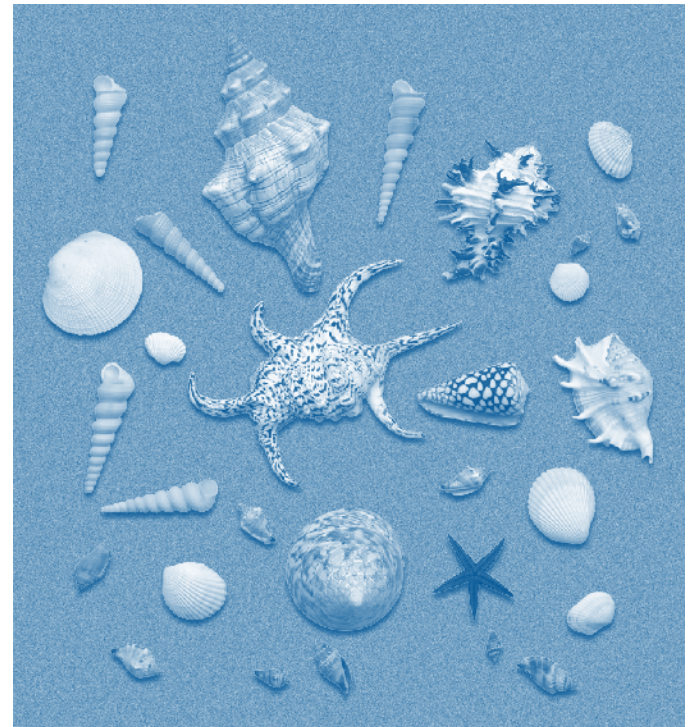
Another technique is to incorporate relatively short-term rather than longer-term fixed income holdings. For example, by investing in five-year government agency bonds rather than long-term Treasury bonds, it is possible to reduce expected risk within your fixed income holdings. This in turn can enable you to retain a higher percentage of equity allocation (and its higher expected returns). The result, if properly constructed, can be a conservative but effective portfolio, with a risk profile that is designed to be "just right" for you.

The Dark Side of Diversification

It's easy to walk a sandy beach, pick up random shells and call them a collection. The collection might be diverse, but clearly it lacks a guiding plan. Too often, investors pick up investments in a similar way. The results, even if diverse, can disappoint. Before your quest for financial independence becomes a potential shell game, we will discuss a few ways that you can avoid getting too much of a good thing.

Quantity rather than quality — Fortunately, many of our clients already have recognized and addressed the common misperception that simply a large number of holdings represents a well-diversified portfolio. In reality a portfolio can hold a very large number of stocks or mutual funds, but still not be properly diversified. For example, owning five or more different U.S. large-cap growth funds or stocks provides only minimal diversification benefit. In this case, all the assets would be invested in the same basket and exposed to the same types of risks. On the other hand, it is possible to hold a **single** DFA core equity fund that is diversified across a variety of risk factors. If that fund happened to match your personal risk profile, you would already have achieved appropriate diversification. (Note, such a precise risk profile match would be unusual, although possible.)

Too many cooks — At the risk of appearing self-serving, we would also caution against translating the need to diversify your investments into the need to diversify management of those investments. Diversification and the amount of risk in your portfolio are no more determined by the number of advisors you use than by the number of stocks you own. Instead, as the academic research indicates,



almost all of your portfolio's risk and return is determined by asset allocation and minimizing costs. When multiple managers are overseeing portions and nobody is overseeing the big picture, it becomes a significantly greater challenge to build and maintain an appropriate, effective overall asset allocation. It can also be more expensive, more time-consuming for you (as you must take on the oversight role yourself), and more likely to result in errors if the proverbial left hand is unaware what the right hand is up to.

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Beyond investment and into wealth strategy —

Diversifying across multiple advisors who are not a unified team can also generate avoidable problems as you seek to plan — and successfully execute — an overall wealth strategy for you, your family and potentially your heirs. For example:

- ▲ Are your investment decisions and performance regularly monitored? Is there an assessment of their ongoing contribution to your financial independence, and vice versa?
- ▲ Is there careful consideration of each player in the mix? Each parent, child and charitable entity within an overall strategy may warrant very different approaches. Each may require a different level of investment risk (asset allocation) and a different balance between taxable and tax-deferred accounts (asset location). At the same time, they must fit into a unified plan.
- ▲ Are you planning for the unexpected? A wealth strategy helps you accumulate, but it also should be built to withstand “shock events” that can damage an otherwise carefully constructed portfolio. Ensuring appropriate amounts and types of long-term care, life and disability insurance can reduce the risk of having to withdraw funds earlier than desired, knocking your strategy off-course.
- ▲ When the day comes that you are ready to start withdrawing funds, such as in retirement, have you developed an appropriate strategy, while continuing to address all of the above?
- ▲ Are you looking out for heirs (if appropriate)? Planning for estate tax funding and ensuring tax-efficient selection of IRA beneficiaries can also help ensure that your vision remains a reality.



You want to be able to take advantage of these and the many other benefits that a carefully coordinated wealth strategy can deliver, while avoiding entanglement in endless planning sessions among too many players. It makes sense to seek a single financial “quarterback” to coordinate these efforts for you, with a vigilant eye toward delivering simplicity combined with sophistication. To achieve this, we believe the best plan is a single plan.

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors’ returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An investment approach based on research by Nobel Prize-winning economists
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting

MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP



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