Perspectives
SECOND QUARTER 2014

Maximizing the Power of Diversification

By Ryan George
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The world's most famous squire, Sancho Panza, cautioned Don Quixote that, "It is the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket." In addition to Quixote, investors would be wise to follow Sancho's sage advice. Many investors' portfolios are over-concentrated in specific sectors, countries and, in many cases, the company for which they work.

Historical data show that efficient diversification of a portfolio may increase the overall return of the portfolio, while accepting lower levels of risk.

The J.P. Morgan chart to the right illustrates the power of diversification. The Traditional Portfolio is diversified into three different asset classes: stocks (S&P 500 Index), bonds (Barclays Aggregate Index) and international markets (MSCI EAFE Index). The annual return for this portfolio from 1994 - 2012 was 7.43 percent with a standard deviation of 10.80 percent.*

***Standard deviation measures the distribution of returns from the mean and is a commonly used measure of risk. A higher number generally means greater volatility.**

In contrast, the More Diversified Portfolio invested in eight distinct asset classes. You can see that this increased level of diversification resulted in higher overall annual returns (7.72 percent vs. 7.43 percent) and a lower standard deviation (9.87 percent vs. 10.80 percent).

Finding the Right Mix

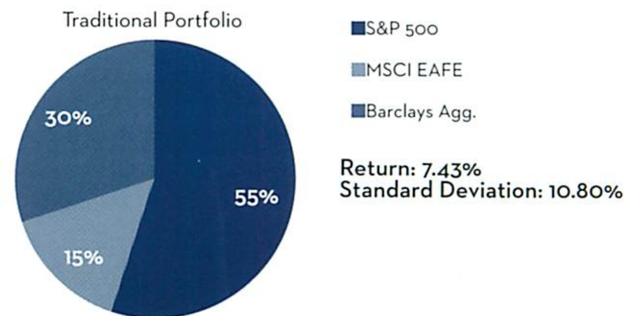
With the S&P 500 Index continuing to reach for new highs despite tepid growth in the global economy and rising tensions in the eastern hemisphere, diversification is as important now as it's ever been. The objective of diversification is to provide you with an all-weather strategy that is individually tailored to your long-term goals. While there is no such thing as a perfect portfolio, your diversified portfolio should meet two important factors: behavioral and investment.

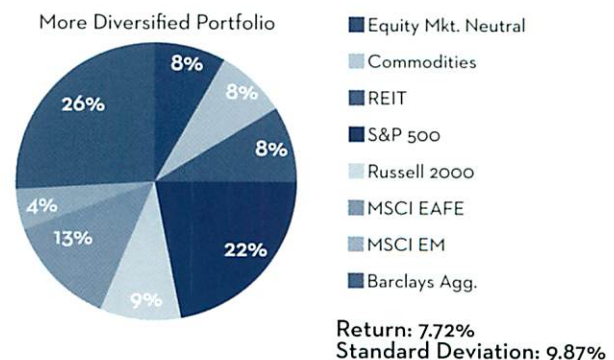
Behavioral Factors - It's important that your diversified strategy's pattern of returns will not cause you to abandon the portfolio during volatile periods.

Investment Factors - The diversified portfolio should be created given your current level of assets and cash flow, time horizon, risk tolerance and financial goals.

The first step in creating a diversified portfolio is sitting down with your financial advisor to discover long-term goals, and then use those goals to explore the right investment mix to achieve them. If you've already had this conversation with your advisor, it may be time to "check in" on your long-term goals to see if you are still heading down the right path.

Maximizing the Power of Diversification (1994 - 2012)





Indexes and weights of the traditional portfolio are as follows: U.S. Stocks: 55% S&P 500; U.S. Bonds: 30% Barclays Capital Aggregate; International Stocks: 15% MSCI EAFE. Portfolio with 25% in alternatives is as follows: U S Stocks: 22.2% S&P 500, 8.8% Russell 2000; International Stocks: 4.4% MSCI EM, 13.2% MSCI EAFE; U.S. Bonds: 26.5% Barclays Capital Aggregate; Alternatives: 8.3% CS/Tremont Equity Market Neutral: 8.3%, DJ/UBS Commodities: 8.3% NAREIT Equity REIT Index. Return and standard deviation calculated using Morningstar Direct. Charts are shown for illustrative purposes only. Past performance is not indicative of future returns. Diversification does not guarantee investment returns and does not eliminate risk of loss. Data are as of 3/31/14. Guide to the Markets - U.S. J.P. Morgan Asset Management.

Not Rocket Science

By Jim Parker
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When the media raises the subject of beating the market through astute stock picking, the name Warren Buffett is usually cited. But what does this legendary investor actually say about the smart way to invest?

Buffett is considered to have such a track record of picking stock winners and avoiding losers, that his annual letter to shareholders in his Berkshire Hathaway conglomerate is treated as a major event by the financial media.[1]

What does he think about the Federal Reserve taper? What could be the implications for emerging markets of a Russian military advance into Ukraine? What does an economic slowdown in China mean for developed markets?

Buffett has a neat way of parrying these questions from journalists and analysts. Instead of offering instant opinions about the crisis of the day, he recounts in his most recent annual letter, a folksy story about a farm he has owned for nearly 30 years.[2]

Has he laid awake at night worrying about fluctuations in the farm's market price? No, says Buffett, he has focused on its long-term value. And he counsels investors to take the same sanguine, relaxed approach to liquid investments, such as shares, as they do to the value of their family home.

"Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations," Buffett said. "For these investors, liquidity is transformed from the unqualified benefit it should be, to a curse."

While many individuals seek to mimic Buffett in analyzing individual companies in minute detail in the hope of finding a bargain, he advocates that the right approach for most people is to let the market do all the work and worrying for them.

"The goal of the non-professional should not be to pick winners," Buffett wrote in his annual letter. "The 'know-nothing' investor who both diversifies and keeps his costs minimal is virtually certain to get satisfactory results."

As to all the predictions out there about interest rates, emerging markets, or geopolitics, there will always be a range of opinions, he says. But we are under no obligation to listen to the media commentators, however distracting they may be.

"Owners of stocks ... too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally," Buffett says. "Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments."

The Buffett prescription isn't rocket science, as one might expect from an unassuming, plainspoken octogenarian from Nebraska. He rightly points out that an advanced intellect and success in long-term investment don't necessarily go together.

"You don't need to be a rocket scientist," he has said. "Investing is not a game where the guy with the 160 IQ beats the guy with 130 IQ."[3]

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[1] "Buffet Warns of Liquidity Curse," Bloomberg, Feb 25, 2014.
[2] Berkshire Hathaway Inc. shareholder letter, 2013, www.berkshirehathaway.com/letters/2013ltr.pdf.
[3] "The wit and wisdom of Warren Buffett," Fortune, November 19, 2012, management.fortune.cnn.com/2012/11/19/warren-buffett-wit-wisdom/.

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