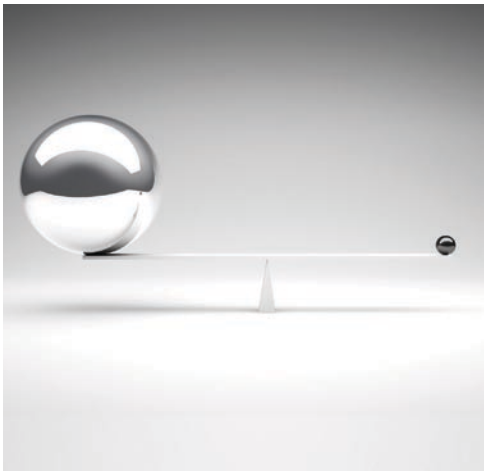
FAMILY-RUN FUND OUTPERFORMS > 78



Embracing the Average

Last year's spectacular S&P 500 gains may have clients demanding more large-cap stocks. Here's how to resist. **By Craig L. Israelsen**

Investors, like the children in Lake Wobegon, prefer to all be above average. That can be dangerous, because striving for above-average returns can itself lead to risky investment maneuvers.

The real challenge for advisors may lie in persuading clients that portfolio diversification — and its resulting average year-to-year performance — is good enough.

To make the point, compare the annual performance of an equally weighted seven-asset portfolio versus the S&P 500 from 1970 to 2013 (see the "Year-to-Year Battle" chart on page 76).

The blue bars in the chart represent the year-to-year returns of the S&P 500, while the maroon bars represent the returns of a seven-asset portfolio consisting of large and small U.S. stocks, non-U.S. stocks, commodities, real estate, U.S. bonds and cash.

The S&P 500 outperformed the multi-asset portfolio 55% of the time, during 24 out of the 44 years — and, indeed, the annual margin of victory was often dramatic. In 1998, for example, the S&P 500 had a return of 28.58% while the multi-asset portfolio returned 0.96% — an S&P advantage of more than 2,700 basis points. The average margin of victory for the S&P 500 in the years that it outperformed the multi-asset portfolio was 833 basis points.

One important rule: Negative returns are disproportionately more damaging to a portfolio than positive returns of the same size.

And yet the two ended up with a 44-year performance that was basically the same. The S&P 500 had a 44-year average annualized return of 10.41% versus 10.29% for the multi-asset portfolio.

BEWARE OF LOSSES

The explanation lies in the down years. There were more of them for the S&P 500 (nine losing years versus five for the multi-asset portfolio), and the depth of the losses was far greater.

The average negative return for the S&P 500 was 15.2% versus 8.7% for the multi-asset portfolio.

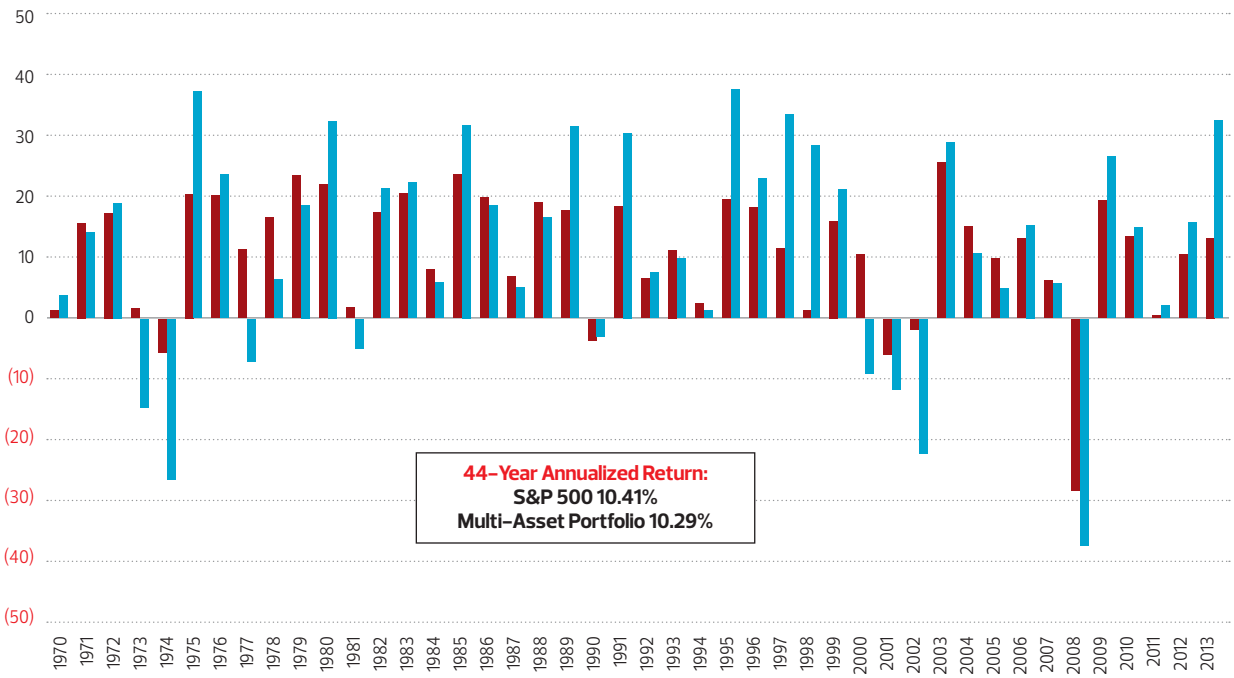
Moreover, both advisors and clients need to keep in mind one important rule: Negative returns are disproportionately more damaging to a portfolio than positive returns of the same size, because the loser portfolio must work so much harder to catch up.

Therefore, a 20% loss requires a 25% gain to break even; a 50% loss requires a 100% gain to break even. And a devastating 75% loss would require a 300% gain to break even.

Even though the S&P 500 frequently outperformed the multi-asset portfolio, these gains were largely undermined by the frequency and magnitude of its large negative returns. That's why "average" diversified returns need to be good enough

YEAR-TO-YEAR BATTLE

ANNUAL RETURNS OF THE S&P 500 (IN BLUE) VS. A 7-ASSET DIVERSIFIED PORTFOLIO (MAROON) FROM 1970–2013.



Source: Lipper, author calculations

for clients — because those diversified portfolios can provide long-term results that are comparable with equities while avoiding the worst risks of the down years.

As is true with most virtues, the benefits of the multi-asset "average" performance become fully apparent only over time. The challenge of building a multi-asset portfolio is in the short run, not the long run.

To put it differently, a multi-asset portfolio will never outperform the best-performing individual asset class in any given year. Multi-asset portfolios are steady, not flashy. Therein lies the problem: The best-performing asset class of last year may create investor envy, which can lead to performance chasing — reallocating all or a portion of a portfolio to last year's winner.

Such an approach is folly, of course, but is only human.

CHASING RETURNS

Which brings us to your clients. In 2013, the S&P 500's returns were fabulous; the index's calendar-year return was 32.4% — roughly two and a half times that of the equally weighted seven-asset portfolio, which returned 13.15% in 2013.

One consequence: Investors have been pouring money into U.S. large-cap stocks. For instance, the Investment Company Institute reports that domestic equity funds had more than $18 billion in positive inflows in 2013.

And despite the stock market's reversal earlier this year, your clients might still be tempted to overallocate to U.S. large-cap equities.

But of course, chasing performance usually ends in tears. Building and staying with a broadly diversified portfolio is the only sane approach for long-term investors.

This creates a teachable moment for an advisor. To use the old fable, the steady performance of the seven-asset portfolio represents the plodding but victorious tortoise — and chasing last year's best-performing

single asset class represents the hare. If you look just at the tumultuous past 15 years (from 1999 to 2013), you'll see that the tortoise had a 6.97% annualized return, compared with a 4.68% annualized return for the hare.

In truth, building a broadly diversified portfolio is really the only logical investment philosophy — both mathematically and emotionally. On the emotional side, clients can avoid the roller coaster caused by chasing the performance of individual asset classes. And we've already covered the mathematical argument: the reality that large losses are disproportionately more damaging to a portfolio than positive returns of the same size.

DIVERSIFICATION: DEPTH VS. BREADTH

FROM 1999–2013, THE BROADER PORTFOLIO HAD HIGHER RETURNS AND LESS RISK.

Year	Depth Diversification (S&P 500)	Breadth Diversification (Seven-Asset Portfolio)
1999	21.04	15.91
2000	(9.09)	10.28
2001	(11.88)	(5.51)
2002	(22.10)	(1.57)
2003	28.69	25.22
2004	10.87	15.08
2005	4.89	9.71
2006	15.79	12.92
2007	5.50	5.94
2008	(36.99)	(27.60)
2009	26.45	19.06
2010	15.05	13.35
2011	2.12	0.27
2012	15.98	10.17
2013	32.41	13.15
15-Year Average Annualized Return	**4.68**	**6.97**
15-Year Standard Deviation of Annual Returns	**19.6**	**12.6**
Growth of $10,000 After 15 Years	**$19,852**	**$27,458**

Source: Lipper, author calculations

DEPTH VS. BREADTH

There is one more aspect of diversification to cover: what I call depth diversification versus breadth diversification.

The S&P 500 is a diversified collection of 500 stocks from a variety of industries, but all of them by definition fall within one asset class: large-cap U.S. stocks. This represents diversification depth. It's important, but breadth diversification is even more important.

Breadth diversification is achieved by combining multiple asset classes — stocks, bonds and diversifiers. This is precisely the logic of a multi-asset investment portfolio.

A properly built portfolio needs both depth and breadth diversification. Depth diversification is achieved by using mutual funds and/or ETFs, while breadth diversification is achieved by using a wide variety of "depth diversified" mutual funds.

Why is breadth diversification important? Look at the "Diversification: Depth vs. Breadth" chart above. Notice the excellent performance of the S&P 500 in several single-year time frames (such as in 1999, 2003, 2006 and 2009-2013). Unfortunately, good years are sometimes followed by meltdowns — as occurred in 2000, 2001, 2002 and 2008 for the S&P 500.

The seven-asset portfolio, by contrast, underperformed in 1999 — but came through 2000-2002 relatively unscathed. After 15 years, $10,000 invested in the seven-asset portfolio, which represents breadth diversification, exceeded the value of the same investment in the S&P 500 by more than $7,600.

Large-cap U.S. stocks are an important "depth" ingredient within a diversified portfolio, but the S&P 500 alone is not a diversified portfolio. It's a good reminder to clients: Even though the S&P 500 has outperformed a multi-asset portfolio over each of the past five years, it is important to keep a longer-term perspective to appreciate the value of breadth diversification. **FP**

Craig L. Israelsen, a *Financial Planning* contributing writer in Springville, Utah, is an executive in residence in the personal financial planning program in the Woodbury School of Business at Utah Valley University. He is also the developer of the 7Twelve portfolio.