April 30th, 2018

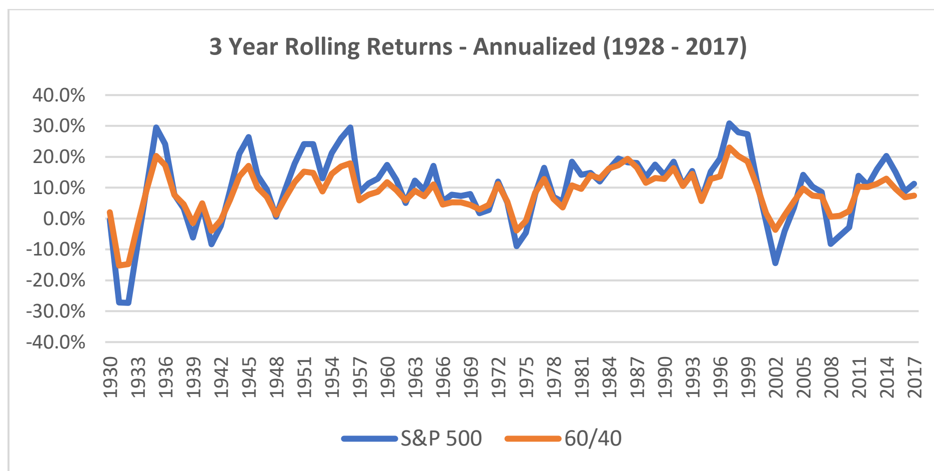
SUMMARY

In our past writings have we discussed the critical benefit of a long-term investment time horizon for investors. We pointed out that though stock market volatility can be considerable in any given year, it is smoothed out with the passage of time. As a result, investors with long term time horizons and/or higher risk tolerance levels maintain a significant competitive advantage when it comes to investing. However, of course, many investors struggle with short term volatility. Because of this, we thought we would touch on another tool that can be helpful to investors this quarter – Diversification. Additionally, because diversification plays a critical role in determining whether we as investors ultimately achieve our goals, we will share a useful tool known as a benchmark which can be used to help monitor its relative effectiveness.

DIVERSIFICATION

Diversification involves the combination of risky assets such as stocks with less risky and uncorrelated assets such as bonds to reduce the overall risk in a portfolio. The use of diversification can be very helpful for investors with shorter investment time horizons, or an interest in reducing risk in their portfolios.

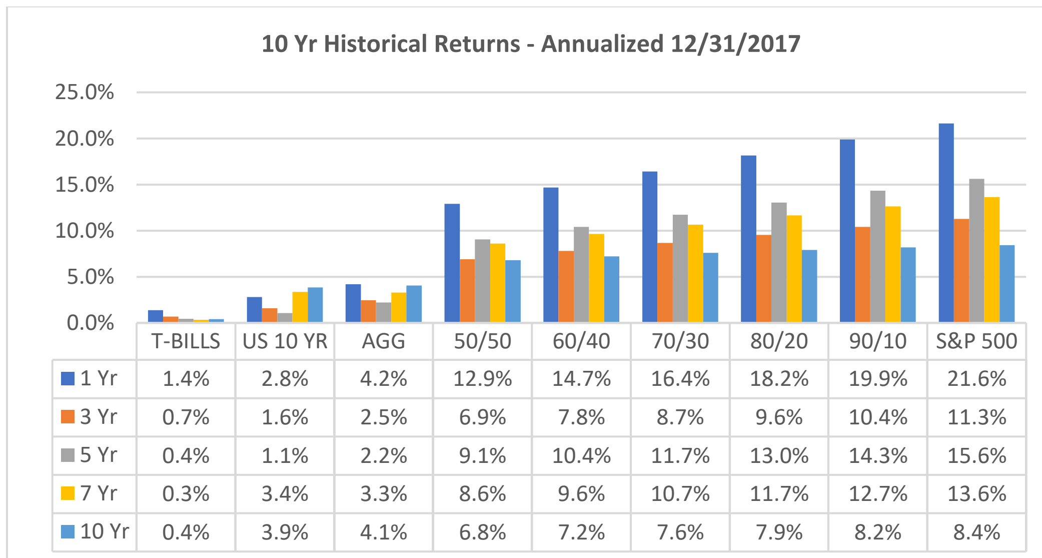
The chart below compares the performance of an investment 100% in stocks against a portfolio that has 60% exposure to Stocks and 40% exposure to bonds, or a 60/40 portfolio in investment vernacular. For the stock allocation we selected the S&P 500 and for bonds we have used 10 Year US Treasury Bonds. The performance is shown on a rolling 3-year basis meaning the first calculation is for the 3-year annualized return from 1928 to 1930, the next is from 1929 to 1931, and so on all the way through the close of last year, when the return from 2015 through 2017 is calculated. In total, returns are calculated over 88 different time periods. We used a 3-year time-period for the chart because in our minds it is the minimum amount of time necessary to consider a meaningful investment in risk assets.



As you can see, on average a portfolio 100% allocated to stocks does better over the period. The average return for the S&P was 10.0% compared to 8.4% for the 60/40 blend. One Dollar invested in the S&P 500 in 1928 would have grown to almost $4,000 by end of 2017, compared to just shy of $1,300 for a 60/40 investment. However, the performance of the 60/40 portfolio, not surprisingly, really stands out during down markets. For instance, the blended index managed a small .6% annualized 3-year gain for the period ending in 2008, while the S&P was down -8.2% annualized. Additionally, the odds of a positive return on a rolling 3-year basis were also higher for 60/40 investors than an investor in the S&P. A 60/40 investor had a 90% chance of a positive return, compared to 83% for the S&P

One could say that a diversified investor gives up some of the upside in their portfolio in exchange for a bit more certainty. The question of how much insurance, or exposure to less risky assets is needed, is answered differently by each of us. We chose a 60/40 blend in our example because it is one of the more popular allocations. The challenge is to determine the appropriate risk exposure to enable us to achieve our goals without exceeding our own individual comfort levels. For many, this level is typically found when they can achieve peace of mind knowing that their future spending needs will be met, while preserving the ability to stay the course with their investments during times of heightened volatility.

The chart below shows a spectrum of exposure to risk over the past 10 years ranging from T-Bills (Cash) to 100% equities. Like before the blended index includes the percentage exposure to stocks and bonds.



	T-BILLS	US 10 YR	AGG	50/50	60/40	70/30	80/20	90/10	S&P 500
1 Yr	1.4%	2.8%	4.2%	12.9%	14.7%	16.4%	18.2%	19.9%	21.6%
3 Yr	0.7%	1.6%	2.5%	6.9%	7.8%	8.7%	9.6%	10.4%	11.3%
5 Yr	0.4%	1.1%	2.2%	9.1%	10.4%	11.7%	13.0%	14.3%	15.6%
7 Yr	0.3%	3.4%	3.3%	8.6%	9.6%	10.7%	11.7%	12.7%	13.6%
10 Yr	0.4%	3.9%	4.1%	6.8%	7.2%	7.6%	7.9%	8.2%	8.4%

**Blended strategies include % exposure to S&P 500 / % Exposure to Barclays Aggregate*

As you can see, there has been a direct correlation between the level of risk taken and the return secured over the past decade. An investor in T-Bills has not been able to keep pace with inflation and has seen little return on their investment. Meanwhile, an investor with 60% exposure to the S&P and 40% exposure

to bonds has seen their investment increase by 9.6% in each of the past 7 years. Of course, in periods of prolonged market gains it is easy for more conservatively positioned investors to start to second guess their exposure to risk. However, rather than thinking of investing as a choice between cash and stocks, or risk off risk on, we believe investors are much better served to focus on making sure that they are maximizing their return for the level of risk being taken in their portfolios. The best way to do this is by using another handy tool known as a Benchmark.

WHAT IS YOUR BENCHMARK

A benchmark is defined as a standard or measure that is used to compare the allocation and return of a given portfolio. It allows us to measure the performance of our investments on a risk adjusted basis by incorporating the percentage exposure of our portfolio to risky and less risky asset classes.

There are of course many more investment asset classes than the S&P 500 and Aggregate bonds that investors may choose from in constructing portfolios. Some would argue that a Benchmark needs to include the percentage exposure to all the asset classes that a portfolio is exposed to. As a result, they create what can become very complicated blended benchmarks that already reflect all the investment allocation decisions that have been made in a portfolio. However, once an asset class has been placed in a benchmark, say international equities, or emerging markets for example, the relative merit of the decision to add international stocks in the portfolio can no longer be determined (both have been detrimental in recent years).

Instead, by creating a simple straightforward two strategy benchmark, as we have done above, we can measure the impact and timing of our additional diversification decisions, or more importantly those being made on our behalf. This approach can be particularly powerful in instances where we, or our advisors are exclusively using passive index funds. In this case the allocation decision, or which asset classes to own and when, is the only ACTIVE decision being made. Why not measure its relative effectiveness?

If you are a client of ours, we spell out your appropriate benchmark and our performance against it clearly on our quarterly statement. If you or your advisor do not calculate it, you can determine it for yourself by adding the percentage exposure to equities as well as your exposure to bonds and cash from your most recent brokerage statement. With this ratio in hand you can now compare your performance against the corresponding blend in the chart above. So, how are your results?

Please feel free to reach out to us anytime if we can be of assistance. We are always happy to meet to discuss our investment approach and/or provide a free assessment on assets outside of our control.

Thank you for your time and consideration -

Best regards,

John Murphy, CFA

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