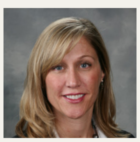
Harnessing the Power of Free Markets



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As the Great Recession recedes in time, its many lessons for investors come into sharper focus.

Imagine it's early in 2007 and you've just invested a substantial portion of your portfolio in a single stock: Bear Stearns. Its stock is selling at a high of $171 and has outpaced the S&P 500 Index by a wide margin in every year since its initial public offering in 1985 through 2006.

Now fast forward to the spring of 2008… shortly after Bear Stearns' CEO states in a press release that the firm's "balance sheet, liquidity and capital remain strong," the firm's shareholders approve the sale of Bear Stearns for $10 per share — a decline of 94% since you purchased the stock in 2007.

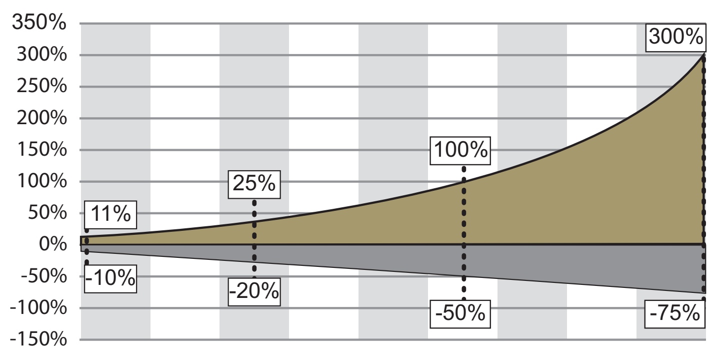
Many investors found themselves in this devastating situation in 2008.

However, other investors made it through that same time period with much less significant losses to their portfolios. Why the difference? In a word: Diversification.

While no investor is immune from the anxiety of a falling stock market, historically proper diversification can help investors decrease their portfolio's overall volatility. Amongst its many benefits, diversification can help you harness the power of the free markets. In a free capital market system, market rates of return are there for the taking. Investors who use market forces, and not fight them, are better positioned to meet their long-term goals.

Large losses like the one in our Bear Stearns example can have a dramatic effect on long-term portfolio growth. The larger the loss, the greater the amount needed to recover or "break-even"… and this amount grows exponentially as losses increase.

As shown in the graph below, if an investment declines 10%, it needs an 11% return to break even. If an investment declines 75%, it needs a 300% return to recover its original value.

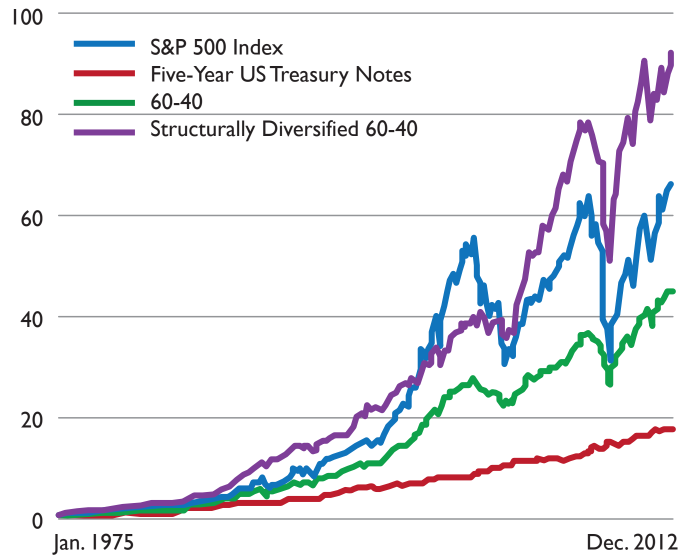


The primary benefit of diversification is its potential to protect a portfolio from large losses like these. Though diversification does not guarantee a profit or protect against a loss, a combination of asset classes may reduce a portfolio's sensitivity to market swings because different asset classes will react differently to adverse events.

For example, the stock and bond markets tend to move in opposite directions; and even when they move in the same direction, they usually don't move to the same degree. So if your portfolio is diversified across both markets, downward movements in one may be offset by positive results in another.

Including both stocks and bonds in a portfolio is the simplest form of diversification. But an investor can lower the portfolio's volatility by including additional asset classes and even diversifying within each asset class. They key is to invest in several different areas — not just one — and to hold securities that don't have the tendency to increase or decrease in price to the same degree at the same time.

Looking at historical index data since the mid 1970s, a structurally diversified portfolio with 60% stocks (equally divided with 15% in U.S. value stocks, 15% in U.S. small stocks, 15% in international value stocks and 15% in international small stocks) and 40% bonds, would have improved both the stability of the portfolio returns and the long-term growth of the portfolio, while significantly decreasing the volatility.



Source: Morningstar Direct 2013. Asset allocations and index portfolio returns are for illustrative purposes only and do not represent actual performance. Hypothetical value of $1 invested at the beginning of January 2007 through December 31, 2012. Assumes reinvestment of income and no transaction costs or taxes. Fully-Diversified portfolios comprised of 40% 5 Year US Treasury Index, 15% Fama/French US Large Value Index (ex utilities), 15% CRSP 6-10 Index, 15% Fama/French International Value Index, 15% Dimensional International Small Cap Index. Portfolios rebalanced annually. Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio. Past performance is not a guarantee of future results. All investments involve risk, including loss of principal. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting.

As shown in the graph on the left, the annualized return for the 60% structurally diversified stock / 40% bond portfolio was even higher than that of the S&P 500 Index with a standard deviation that was much lower — only two-thirds that of the S&P 500. The higher return and lower volatility of the structurally diversified portfolio over the period 1975 through 2012 lead to significantly greater growth in wealth when compared to the S&P 500.

Diversification is one of the most important elements in managing the risk of your investment portfolio because it can reduce volatility and reduce the potential of large losses. And just as important, diversification can help ease investment anxiety and allow you to harness the power of free markets.

Sources:

Bary, Andrew, "How Sweet It Is.", Barron's (August 2004)

Bryan-Low, Cassell, and Kate Kelly. "A Stake Through the Heart." Wall Street Journal, (March 2008)

Bear Stearns Companies Inc. Press release (March 2008)

Past performance does not guarantee future results and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Stock investing involves risks, including increased volatility (up and down movement in the value of your assets) and loss of principal. Implementing a short-term fixed income investment strategy or rebalancing cannot guarantee a profit or protect against a loss. The buying and selling of securities for the purpose of rebalancing may have adverse tax consequences.