CLIENT **BULLETIN**

Independent Financial Advisors

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Some Keys to Investing Success: Diversification and Rebalancing

Investors often think that their investing "strength" is directly proportional to the percentage of their portfolio that's invested in stocks. Those investors with 100% in stocks are masters of the universe, the theory goes, and those with bonds are wimps. A recent study by John Bogle, former CEO of Vanguard funds, indicates just the opposite.

From the peak of the Internet bubble seven years ago until now, a portfolio containing only the Vanguard S&P 500 stock index fund would have just barely broken even after all that time. A portfolio containing 80% stocks, however, with the rest in bonds, would have broken even in November 2004, returning, over the seven-year period, 4.0% per year. Even better, a portfolio with 50% in stocks and 50% in bonds would have broken even more than a year earlier, in May 2003, with total returns of 4.7% per year. By the way, the stocks in this Bogle study consisted of S&P 500, U.S. small-cap and foreign. Keep in mind that the above returns are lower than average due to the severe bear market that was a part of this seven-year period.

Granted, stocks over long periods of time do better than bonds, so you need to know that to put the Bogle study in perspective. Rarely do bonds do as well as they did over the last 7 years and rarely do stocks do as poorly. The lesson to be learned from these statistics is that diversifying away from stocks may be valuable. During some periods of time, holding commodity futures helps a portfolio's total return. At other times, having a dollop of U.S. real estate is helpful. And since we don't know when various investment categories (e.g. foreign small-cap stocks, foreign bonds, foreign real estate, emerging markets stocks and bonds, as well as the ones mentioned above) are going to do well vis-à-vis the S&P 500 Index, it makes a lot of sense to hold them all.

As in the Bogle study, what tends to happen when you hold a variety of investment categories is that your overall total return tends to hold up much better, since some investments zig when others zag. Put another way, it's good to hold some investments that do well in down markets and others that do better in up markets. Psychologically this helps investors to hang in there during bad markets, since some of the volatility is dampened through diversification of risk, resulting in a smoother ride.

Another ingredient for investing success is regular rebalancing. Normally I recommend doing it every 9 to 24 months, depending upon volatility in the markets. It's a tough thing for investors to do, since rebalancing means selling some of what is still doing very well and buying some of what has been disappointing you. It is very counter-intuitive and not something that comes naturally to most investors. But, of course, you, as my clients, don't need to worry about that because I do it for you.

Rebalancing doesn't just help smooth out the volatility and thereby reduce risk in a portfolio. It can also help a portfolio's performance. In the Bogle study, if you were to rebalance annually the 80%/20% stock/bond portfolio, your average returns over the last 7 years would have risen from 4.0% to 4.3%. Similarly with the 50% stock portfolio, returns would have risen from 4.7% to 5.4%. Over the 7-year period in question, rebalancing a $1 million portfolio every year would have raised the ending value from $1.38 million to $1.45 million.