



**STRUCTURED
INVESTING**
In An Unstructured World

Structured Investing STRATEGY REPORT

LORING | WARD

The Power of Effective Diversification

by Joni Clark, CFA, CFP®, Chief Investment Strategist, Loring Ward

Diversification is the single most important element of constructing and managing the risk of your investment portfolio.

“Don’t put all of your eggs in one basket.”

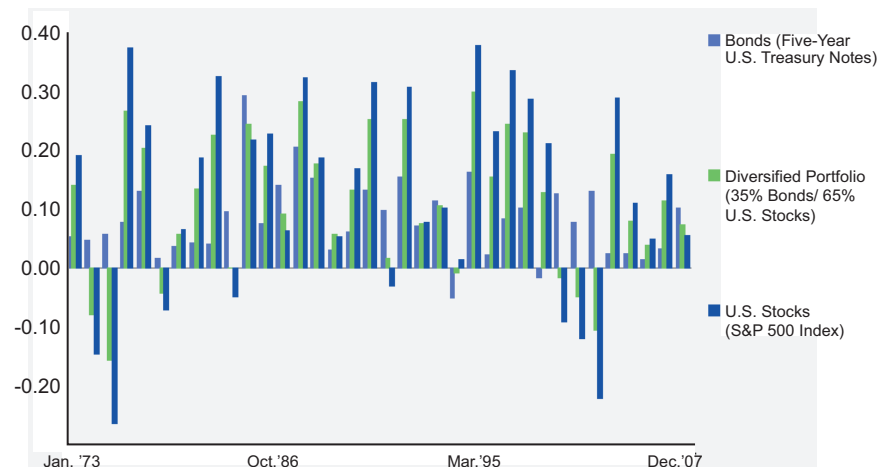
As an investor, you may have heard this old saying used to emphasize the need for a diversified portfolio.

However, in the last several decades, groundbreaking academic research has significantly changed our understanding and application of successful principles of diversification. Most notably, Nobel Prize winner Harry Markowitz’s work on *Diversification and Portfolio Risk* found that by combining multiple asset classes, an optimal portfolio can be constructed to maximize return for any given level of risk. While some investors’ portfolios fully reflect this research, many still do not.

Though diversification does not guarantee a profit or protect against a loss, a combination of asset classes can potentially help reduce a portfolio’s sensitivity to market swings because different assets — such as bonds and stocks — 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 do not move to the same degree. If your portfolio is diversified across both markets, downward movements in one may be offset by positive results in another.

FIGURE 1 — Stocks, Bonds and a Diversified Portfolio

Annual Returns 1972 through 2007



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Figure 1 shows the annual returns of bonds (as measured by Five-Year Treasury Notes) and U.S. stocks (as measured by the S&P 500 Index) and a combination of 35% bonds/65% U.S. stocks from the beginning of 1972 to the end of 2007. The magnitude of returns for stocks, both positive and negative, is much greater than those of bonds in almost every year, with only a few exceptions over the 36-year period. By combining stocks and bonds, the returns are more consistent and less volatile, as illustrated by the green bar in Figure 1 and the longer-term return and risk statistics presented in Figure 2.

FIGURE 2 — Stocks, Bonds and a Diversified Portfolio
Annualized Returns and Risk 1926 through 2007

	Annualized Returns	Risk (Standard Deviation)
Bonds (Five-Year Treasury Notes)	5.3%	4.4%
U.S. Stocks (S&P 500 Index)	10.3%	19.1%
Diversified Portfolio (35% Bonds/65% U.S. Stocks)	9.0%	12.6%

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In Figure 2, "Risk" is defined as the standard deviation of annual returns. Standard deviation is a statistical measurement of volatility and provides an indication of how far the return of an investment moves above or below the historical average. The greater the standard deviation, the riskier an investment is considered to be.

Assuming a normal distribution of probability, there is a 99.7% probability that an annual return will be within three standard deviations of the historical average return. Based on the data presented in Figure 2, U.S. stock returns in any given year are expected to be within +57.3% or -57.3% (three times the standard deviation of 19.1%) from the historical annualized return of 10.3%. In other words, the annual return for U.S. stocks would be expected to be between -47.0% (-57.3+10.3) and +67.6% (+57.3+10.3). The comparable probability distribution of annual returns for the diversified portfolio would be between -28.8% and +46.8%. Therefore, the expected annual downside risk potential of the diversified portfolio in any given year is significantly lower (-28.8% vs. -47.0%) than the downside risk of U.S. stocks alone. Although the annual upside potential of the diversified portfolio may also be more limited (46.8% vs. 67.6%), the long-term growth potential of the diversified portfolio is often greater. This may seem illogical given the fact that both the annual upside return potential and the historical annualized return for U.S. stocks are greater, but it underscores the impact of volatility and large losses on long-term portfolio growth.

As shown in Figure 3, the larger a loss, the greater the amount needed to recover or "break-even" ... and this amount grows exponentially as losses increase. For example, if an investment declined 10%, it would require a +11% return to break even. If an investment declined 75%, it would require a +300% return to restore the investment to its original value. This is why diversification's potential to protect a portfolio from large losses is so important.



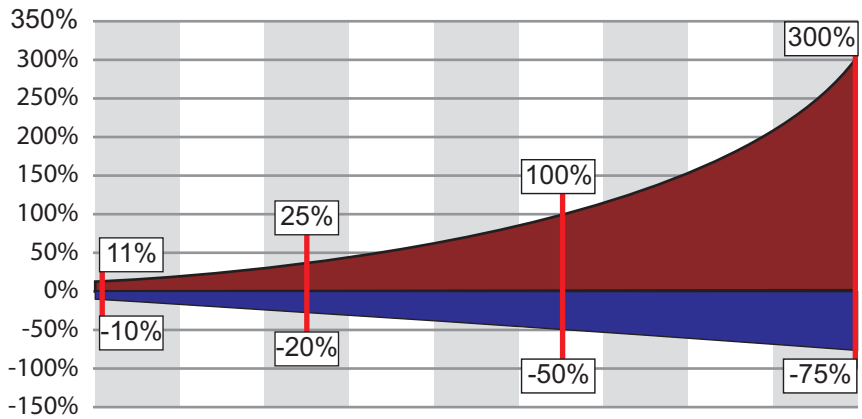
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FIGURE 3 — Return Required to Break-Even after a Loss



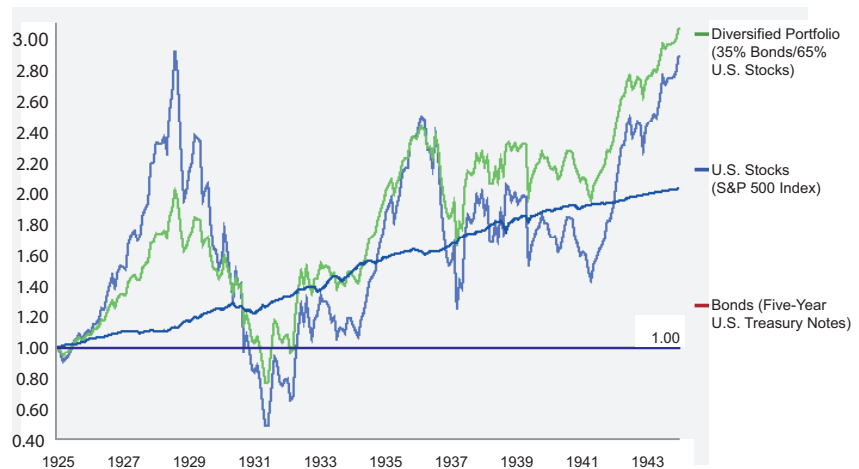
For illustrative purposes only.

Consider a \$100,000 investment portfolio which declines by 10%, or \$10,000. The portfolio, which is now only valued at \$90,000, must earn \$10,000 to break-even. But to gain \$10,000 on a smaller principle value of \$90,000, the portfolio must earn a return of +11.1%. A loss of 75% on a \$100,000 portfolio would leave a principle value of only \$25,000. To recover \$75,000 from this remaining \$25,000 would require a return of +300%.

The actual time required to recover losses is largely dependent on the market environment and/or the sequence and magnitude of returns following the loss. Depending on individual circumstances, as the return required to recover grows, a full recovery may simply not be achievable in an investor's lifetime.

Let's look at the losses and recovery times of three different historical market environments when U.S. stocks suffered significant declines.

FIGURE 4 — Stocks, Bonds and a Diversified Portfolio 1926 through 1944



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The first time period, shown in Figure 4, began in 1926 with a strong bull market for stocks. U.S. stocks, as measured by the S&P 500 Index, grew nearly 300% in less than four years until the market crash in October of 1929. Stocks subsequently lost more than 80% before they found a bottom in June of 1932.

It took more than 12 years for stocks to fully recover the losses. In comparison, the diversified portfolio with 35% in bonds and 65% in U.S. stocks would have gained only 212% from 1926 to the crash of 1929. However, the diversified portfolio would have suffered reduced losses that were fully recovered in just over 4 years. The long-term growth of the diversified portfolio outpaced that of stocks during the 19-year period from 1926 through 1944.

The 1970s market period (Figure 5) encompassed both strong bull and bear markets for stocks; it was also somewhat unusual because it was a market environment that clearly favored bonds.

FIGURE 5 — Stocks, Bonds and a Diversified Portfolio 1970 through 1979

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During the bull market that began in July of 1970 through the end of 1972, stocks gained 76%, as compared to the diversified portfolio return of 57%. Stocks tumbled in the subsequent period, losing 43% from January 1973 through September 1974, compared to a more restrained loss of 29% for the diversified portfolio. The strong market environment that followed in 1975 and



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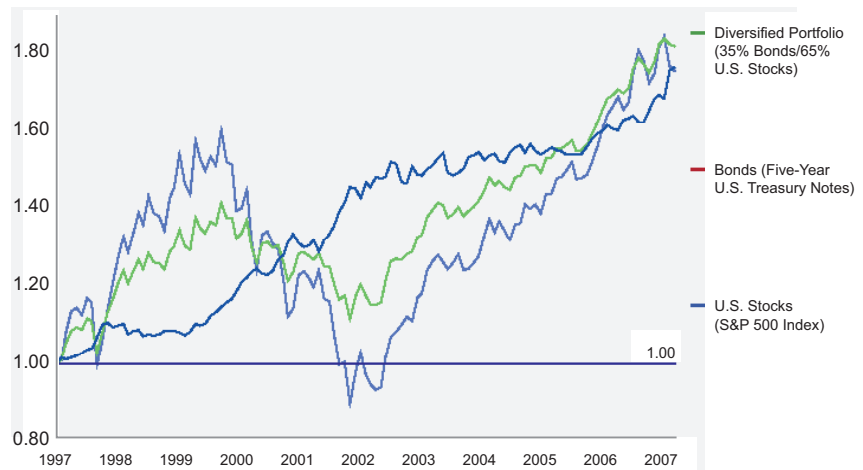
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FIGURE 6 — Stocks, Bonds and a Diversified Portfolio 1998 through 2007



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Again, the long-term growth of the diversified portfolio outpaced that of U.S. stocks for the entire decade, gaining 184% versus 178% for stocks. Bonds finished the decade up 179%, just above stocks.

Including both stocks and bonds in a portfolio is the traditional approach to diversification. But this kind of diversification may result in missed opportunities and unnecessary risks. An investor can lower a portfolio's volatility even further through effective diversification by including additional asset classes and diversifying broadly within each asset class. The 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.

International asset classes are an important component of effective diversification since international markets (and asset classes within those markets) have not — historically — moved in unison with the U.S. market.

Although the economies of various nations are increasingly interconnected, significant differences among governments and markets remain. As shown in Figure 7, the performance of individual country markets can differ substantially from one country to the next and from year to year. Even when country markets move in the same direction, the degree of change may be very different. This variability in country returns is the main risk-reducing power of global diversification.



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FIGURE 7 — Annual Equity Returns of the U.S. and Developed International Country Markets 1983 – 2007

Australia	Germany	Singapore
Austria	Hong Kong	Spain
Belgium	Italy	Sweden
Canada	Japan	Switzerland
Denmark	Netherlands	United Kingdom
France	Norway	United States

1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Highest Return
80.41	46.99	176.27	121.22	43.00	53.61	103.91	10.29	49.51	32.29	116.67	23.57	44.11	40.05	44.25	67.76	99.42	5.83	1.68	16.56	58.03	71.52	28.31	49.36	41.20	
68.28	39.05	135.23	108.31	36.91	52.70	46.28	9.18	33.65	17.24	67.97	21.44	37.14	37.22	35.50	52.53	79.76	4.85	-5.63	-1.34	55.70	43.53	25.52	46.71	35.21	
54.15	16.88	131.71	99.41	35.07	48.32	45.53	6.35	30.07	6.39	45.75	18.33	33.39	33.07	34.54	49.90	61.54	3.47	-10.90	-7.25	54.73	38.39	24.64	45.12	34.43	
49.28	11.36	105.76	78.39	13.23	42.40	43.92	0.66	24.94	6.29	42.02	11.70	29.83	28.64	33.38	41.53	59.51	-0.89	-11.34	-7.33	54.73	36.28	24.50	43.39	29.57	
36.44	10.23	82.03	78.36	11.66	37.86	42.29	-0.91	17.83	2.80	37.00	11.55	27.72	27.51	25.43	30.14	51.77	-1.31	-12.22	-10.30	54.63	32.49	24.26	38.77	28.35	
31.92	8.11	76.60	65.60	9.25	36.40	36.14	-3.15	17.81	2.30	35.67	8.23	25.88	27.44	24.58	29.44	31.68	-4.10	-12.39	-10.30	52.27	30.82	16.33	36.66	28.34	
31.75	5.31	68.62	56.10	7.86	35.38	35.78	-3.19	16.55	-1.46	35.28	6.70	22.58	26.34	23.77	23.53	29.26	-4.32	-14.06	-11.05	49.94	30.34	16.02	36.54	25.59	
29.10	4.46	60.30	45.18	7.06	33.35	31.82	-6.22	16.02	-3.67	35.18	5.40	21.26	23.24	22.61	23.22	21.92	-9.94	-14.80	-13.21	39.39	28.93	14.37	35.99	23.95	
24.53	4.32	59.62	42.28	5.66	28.10	30.01	-9.36	15.75	-10.28	32.81	4.66	18.78	21.80	13.56	17.82	20.03	-11.54	-18.61	-14.96	38.19	24.98	13.85	34.48	20.59	
23.52	0.09	56.94	40.73	2.91	20.60	26.20	-10.97	15.62	-10.64	29.76	3.76	16.41	21.19	12.93	13.96	17.62	-11.97	-20.44	-15.22	37.81	22.27	10.31	32.49	13.24	
23.29	-4.92	54.73	35.29	2.29	14.61	21.87	-11.68	14.42	-10.84	28.53	3.54	16.09	16.47	11.94	8.98	12.44	-12.84	-21.36	-15.29	35.90	22.20	9.92	31.38	8.36	
20.38	-5.70	53.04	34.75	2.23	14.25	21.36	-13.84	13.76	-14.22	28.09	1.13	14.12	13.57	11.20	6.07	12.08	-14.75	-22.11	-16.04	32.31	19.57	9.88	30.86	6.06	
18.11	-10.91	51.68	33.37	2.00	14.17	19.41	-13.84	8.91	-14.43	25.45	-1.61	11.19	12.59	6.25	5.03	6.88	-15.59	-22.36	-17.79	31.26	18.48	9.05	30.61	5.44	
15.67	-11.95	43.03	26.96	-4.12	13.55	17.30	-15.32	8.29	-21.45	24.43	-4.82	6.47	12.03	1.58	0.34	4.83	-15.86	-22.39	-20.84	29.93	16.17	8.40	30.35	5.29	
2.95	-13.67	31.08	16.28	-9.46	11.46	9.75	-17.53	8.15	-21.86	23.51	-4.86	6.02	4.51	-10.43	-2.90	-0.26	-16.85	-23.42	-21.19	29.04	15.86	7.35	27.40	2.17	
-2.08	-21.71	19.55	7.44	-13.82	6.17	9.29	-19.20	-1.83	-22.22	20.90	-5.18	1.05	2.27	-23.28	-7.43	-7.03	-21.27	-26.60	-23.09	28.41	14.96	5.14	17.80	0.62	
-2.84	-26.92	12.24	1.25	-21.31	5.93	8.38	-21.00	-12.23	-22.30	15.10	-6.28	0.70	-6.88	-23.67	-12.86	-9.11	-27.73	-27.18	-30.49	28.22	12.24	4.41	14.67	-2.73	
-7.12	-35.82	-22.18	-2.52	-24.75	0.58	1.72	-36.11	-15.50	-28.25	9.15	-28.91	-4.73	-15.50	-30.05	-30.06	-14.27	-28.16	-29.41	-33.19	22.80	10.14	1.90	6.24	-4.23	Lowest Return

Source: Morgan Stanley Capital International (MSCI) — February 2008. MSCI developed markets country indices (net dividends) with at least twenty-five years of data. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes and different methods of accounting and financial reporting. Past performance is not a guarantee of future results.

By including both U.S. and international investments, a portfolio's diversification has historically been improved (better return and risk characteristics). For example, Figure 8 displays the historical annualized returns and risk for U.S. stocks, international stocks and a globally diversified portfolio of 50% U.S./50% international stocks since the early 1970s.



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FIGURE 8 — Return and Risk for U.S. and International Investments
1972 - 2007

	Annualized Returns	Risk (Standard Deviation)
U.S. Stocks (S&P 500 Index)	11.2%	15.0%
International Stocks (MSCI EAFE Index)	11.1%	16.5%
Globally Diversified Portfolio (50% U.S. Stocks/ 50% International Stocks)	11.4%	13.9%

Sources: Standard & Poors and Morgan Stanley Capital International (MSCI) — February 2008. MSCI Europe, Australia and Far East Index (net dividends). Index performance does not reflect expenses associated with the management of an actual portfolio. You cannot invest directly in an index. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes and different methods of accounting and financial reporting. Past performance is not a guarantee of future results.

Over the last 36 years, international stocks (as measured by the MSCI EAFE Index) have earned an annualized return that is slightly lower than the return on U.S. stocks, with greater volatility. The true benefit of diversification can be clearly seen when combining both asset classes. Allocating 50% to U.S. and 50% to international stocks results in a historical annualized return that is higher than the return provided by U.S. stocks or international stocks alone, and the combined volatility is lower than either asset class.

The benefits of this more effective diversification approach can be amplified when a portfolio is constructed according to the *Structured Investing* principles behind all Loring Ward model portfolios. Typically, many individual and institutional portfolios have international allocations of less than 20%. However, the U.S. accounts for less than half of the world's stock market capitalization, and this percentage continues to shrink. Approximately 95% of the world population lives outside of the U.S., and 72% of the world's gross domestic product (GDP) is generated outside of the U.S. This is why *Structured Investing* portfolios with greater weighting in international stocks offer significant levels of global diversification.

Over time, markets have shown a strong relationship between risk and reward. This means that the compensation for taking on increased levels of risk is the potential to earn greater returns. Accordingly, *Structured Investing* portfolios attempt to take rational, compensated risks based on research derived from the Fama-French Multi-Factor Model which shows that there are three main factors or sources of potentially higher returns with higher corresponding risks:

1. Invest in Stocks
2. Emphasize Small Companies
3. Emphasize Value Companies

Since the early-1970s, compared to a traditionally-diversified portfolio, a structurally-diversified portfolio with 35% bonds and 65% stocks (15% total U.S. market, 15% U.S. value stocks, 12% U.S. small stocks, 15% international large stocks, 8% international small stocks) improved both the portfolio's stability of returns, decreasing volatility significantly, and its long-term growth.



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As shown in Figure 9, the annualized return for the structurally-diversified portfolio was even higher than that of the S&P 500 Index, with a risk level that was much lower.

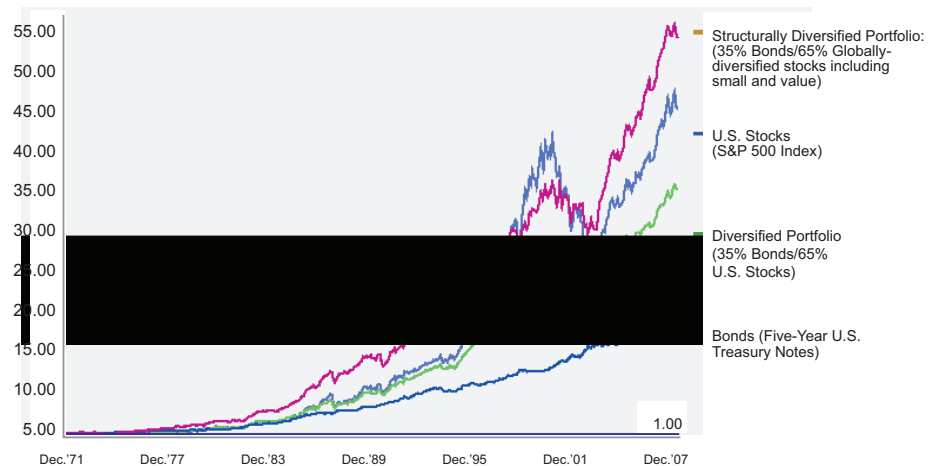
FIGURE 9 — Stocks, Bonds and Diversified Portfolios
Annualized Returns and Risk 1972 through 2007

	Annualized Returns	Risk (Standard Deviation)
Bonds (Five-Year Treasury Notes)	7.9%	5.6%
U.S. Stocks (S&P 500 Index)	11.2%	15.0%
Diversified Portfolio (35% Bonds/ 65% U.S. Stocks)	10.3%	10.2%
Structurally-Diversified Portfolio (35% Bonds/65% Globally-diversified stocks including small and value)	11.8%	10.0%

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Figure 10 shows that the long-term growth of the structurally-diversified portfolio from 1972 to 2007 was significantly greater than both the traditionally-diversified portfolio of 35% bonds/65% stocks and the S&P 500 Index. Over this period, the cumulative return of the structurally-diversified portfolio was 5,503% versus 4,551% for the S&P 500 Index — a difference of more than 950%.

FIGURE 10 — Stocks, Bonds and Diversified Portfolios 1972 through 2007



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Notes and 65% S&P 500 Index. "Structurally-Diversified Portfolio (35% Bonds/65% Globally-diversified stocks including small and value)" series represents 35% Five-Year Treasury Notes, 15% CRSP 1-10 Index, 15% Fama-French U.S. Large Value Index, 12% CRSP 6-10 Index, 15% Dimensional Developed International Large Composite Index, and 8% Dimensional International Small Cap Index. CRSP is the Center for Research in Security Prices. CRSP ranks all NYSE companies by market capitalization and divides them into 10 equally-populated portfolios. AMEX and NASDAQ National Market stocks are then placed into deciles according to their respective capitalizations, determined by the NYSE breakpoints. Hypothetical portfolios may not reflect the impact material economic and market factors might have had on Loring Ward's decision making if Loring Ward was actually managing clients' money at that time. Performance results do not represent actual trading, but were achieved using backtesting with the benefit of hindsight; actual results may vary. All investments involve risk, including loss of principal.

Although the benefits of diversification are often amplified during bear markets, it is just as important to maintain a diversified portfolio during strong bull markets. Some investors may be tempted to move away from diversification, and attempt to beat the market by concentrating investments in a few "hot" stocks, industries or asset classes. These investors often fail to achieve market rates of return, and even worse, can suffer substantial losses when the market turns bearish.

Diversification is the single most important element of constructing and managing risk of your investment portfolio. It can reduce volatility and reduce the potential of large losses in your portfolio. The key is to diversify effectively and structurally with an efficient combination of asset classes and to find the most suitable trade-off between risk and return. This helps increase the likelihood of an investor achieving his or her financial goals without taking any more risk than absolutely necessary. 🌐