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Traditional Diversification:

A Tale of the World's Smartest Man

There once was a man who was regarded as the Smartest Man in the World. Each year on December 31 he would invest 100% of his investable assets into a single asset class, and each year his investment returns were stellar. He always knew the best performing asset class to invest in year after year according to Callan Associates Callan Chart. For example, in 2006 he knew to be 100% invested in Real Estate, that year's best performing asset class. Then in 2008 he knew to switch to 100% US Treasuries, that year's best performer. It was an impossible skill but somehow he had mastered it.

Each year at a family gathering on New Year's Day he would tell his family all about his investment success and his brilliant investment clairvoyance. His Brother-in-Law, who had to endure this bragging about investment performance, decided he would try to replicate the Smartest Man's success by following his investment strategies. However the Brother-in-Law was always a year behind the Smartest Man since he did not know what the strategy was until the following New Year, and he assumed if an investment did well last year, it should be ok this year. So when the Smartest Man was reallocating his portfolio into his next successful pick, the brother-in-law was investing into his old strategy.

For ten years this went on and finally in 2013 the brother-in-law decided to find out why he was not having the same success as the Smartest Man. Below is a summary of his analysis between 2003 and 2012 gross of fees and taxes which can vary by individual.

INVESTOR	AVGERAGE RETURN	STANDARD DEVIATION	RESULTS
Smartest Man	24.3%	10.5%	The Smartest Man did the impossible; he had great returns and the least volatility as measured by Standard Deviation.
Brother-in-Law	2.7%	23.2%	By being one year late replicating the Smartest Man's strategy, the Brother-in-Law ended up with the worst average returns, and the highest volatility
Indexing	7.1%	18.3%	If the brother-in-law would have utilized a passive indexing strategy comprised solely of large cap stocks represented in the S&P 500, he would have performed over 2 ½ times better with over 20% less volatility.
Diversified	8.8%	12.4%	If the brother-in-law would have utilized a diversified strategic investment strategy comprised of 60% invested in stocks (25% large cap, 20% small cap, 15% International), 30% bonds, and 10% REITS would have performed 3.2 times better with over 45% less volatility.

Efficient market hypothesis suggests that timing the market perfectly is impossible because all information impacting stock movement is already factored into current pricing. The hypothesis also suggests that when markets are efficient one of the best ways for investors to earn a solid return is to stay broadly diversified and to keep their costs low. The story above shows how some investors can easily fall victim to over emphasizing yesterday's winners, and how a diversified portfolio could help investors to stay on track.

(1) Returns were calculated using the annual return data from 2003-2013from the following: iShares. Foreign stocks are represented by the MSCI EAFE Index; Large cap stocks are represented by the Standard & Poor's 500® Index; Mid cap stocks are represented by the Standard & Poor's MidCap 400 Index; Small cap stocks are represented by the Standard & Poor's SmallCap 600 Index; Real estate is represented by the Dow Jones U.S. Real Estate Index; US corp bonds are represented by the iBoxx $ Liquid Investment Grade Index; US gov't bonds are represented by the Barclay's U.S. 3-7 Year Treasury Bond Index. This material has been obtained from sources generally considered reliable. No guarantee can be made as to its accuracy. This is not intended to represent or predict the performance of any particular investment. Past performance is not an indicator or guarantee of future results. An investor cannot invest directly in an index.
(2) Standard deviation is a commonly used measurement for the amount of risk in an investment. Higher standard deviation signals a more volatile, and therefore risky, investment.