The Week

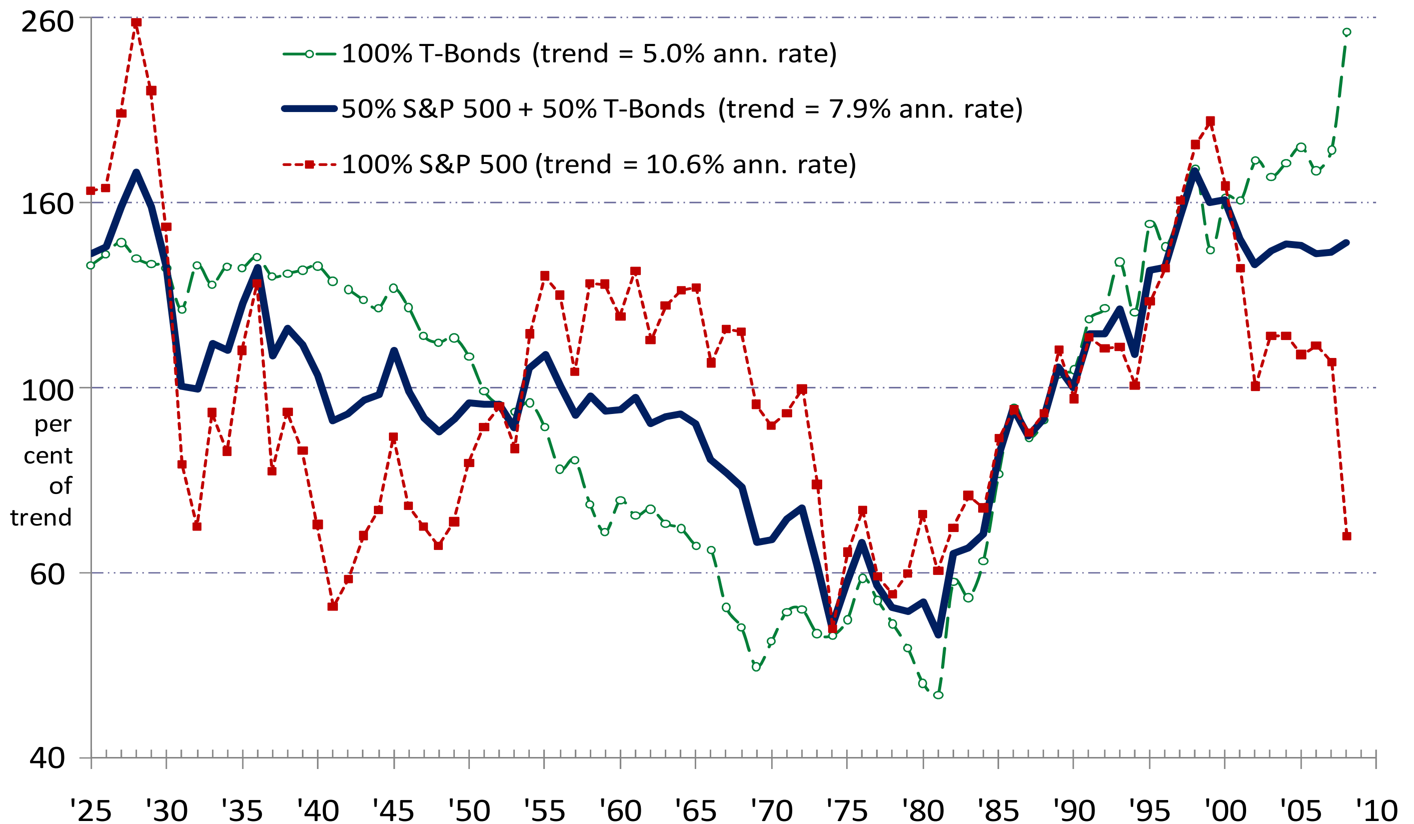
WACHOVIA SECURITIES

January 20, 2009 Tom McManus, Chief Investment Officer

Diversification Still Provides Long-Term Benefits, Despite '08

- Investing has never been easy, but a string of good markets can make it seem so. Economies and risk assets like stocks are inherently cyclical and volatile. Our experience and belief is that ownership of good businesses will provide opportunities for attractive risk-adjusted returns over the long haul. Diversification cannot guarantee a profit or prevent losses; but it tends to smooth out the inevitable bumps. Investors need patience and fortitude to allow it to work.
- We are hopeful — even optimistic — that the economy will begin a recovery sometime in the latter half of 2009. When it does, the equity market will probably anticipate the recovery by advancing ahead of the improving economic data, if history is any guide. But just as we know that a warm day in February doesn't mean Spring has arrived, so also we should be wary about designating any market rally as a precursor to economic recovery.
- Investment results last year were discouraging for holders of U.S. equity portfolios and other risk assets like international and emerging market equities, high yield bonds etc., partly because these assets performed more "in-line" with each other than many had been expecting. As the market fell, correlation among these assets rose higher than predicted by statistical models. Even shares of the highest quality companies — generally known for their defensive characteristics in difficult times — were hit when the market fell. Most are down a good deal less than shares of economically-sensitive companies, financial stocks, or the broad market averages. In some sense, stocks like these are the "innocent bystanders" in one of the worst market routs in decades.
- If the defensive stocks fell less steeply in the bear phase, doesn't that mean they have less to gain in the recovery? Yes, in all likelihood. Why, then, should we focus on stocks like these as the core of our equity investment strategy in 2009? In a word, risk.
- One thing we do not know for sure is when the recovery will begin. So far, the U.S. economy still seems to be slipping, and the international news is worse. While there is a wide range of investments that we consider to be "recovery beneficiaries," we think investors should not risk too much on recovery now.
- Many companies in the large capitalization growth universe enjoy stable cash flows and little or no debt. These characteristics are appealing during a credit crunch as they provide both a defensive moat and perhaps the opportunity to pursue strategic acquisitions at advantageous prices. Our models indicate that they are attractively priced when compared to bond yields of their own companies, and they are more likely to meet earnings expectations if the economy remains sluggish.
- How should we evaluate risk? Mostly we equate risk with "danger," or "hazard," and we take steps to avoid it, just as we buy insurance to protect against loss. The steps we take to avoid portfolio losses are not a waste, just as we shouldn't view our homeowners' insurance premium as a waste of money if no loss occurs. In this sense, the chance that an asset (like one's home) might appreciate more than expected is not really viewed as a risk.
- In a more theoretical sense, risk is the possibility of loss or disadvantage. Often, we see the term "risk" applied to the annual standard deviation, or volatility of a particular asset class like stocks or bonds. Standard deviation (or volatility) is the amount that a particular asset bounces around its average return. If two assets provide the same average return, the one that performs more steadily is considered more valuable, as one can either invest more or liquidate the investment and be more confident to achieve an appropriate rate of return.

Another Look at a Rebalanced Portfolio of Stocks + Bonds: Driving in the Middle …



Note: Based on historical data of the S&P 500 and long-term Treasury bonds from 1926-2008. Chart illustrates the indexed performance of two fixed portfolios (100% stock and 100% bonds) together with the indexed performance of a mix of 50% stock and 50% bonds, rebalanced annually. Each portfolio is shown relative to its own long-term trend. Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment. Source: Federal Reserve, Morningstar, Standard & Poor's.

This week's chart is an extension of the theme we discussed in last week's issue. We showed how a simple portfolio, diversified among just 2 asset classes, has worked to investors' benefit over time. The 100% stock portfolio provided average annual returns of around 10.5% per year, with annual standard deviation (risk) of nearly 20%. The 100% Treasury bond portfolio was neither as strong nor as risky as the stock portfolio, providing about half of the return with about half as much risk. Yet as you can see, it is the bond portfolio that is most extended relative to its own trend.

The important takeaway was that simple combinations of stocks and bonds — if rebalanced periodically — have tended to provide more return per unit of risk than one might expect by simply averaging the statistics of the separate asset classes. The historical figures show that a 50% stock+ 50% T-Bond portfolio boosted the annualized return of the all-bond portfolio by nearly 3% per year with a meaningfully smaller increase (+2.2% per year) in risk. This net benefit accrued over time.

The chart above shows the actual returns of each of the 3 portfolios relative to its own long-term trend. Note the sharp divergence in bond and stock returns in 2008 (this is most noticeable when using T-Bonds). It should also be easy to see that the all-stock portfolio bounces around much more year-to-year, while the other portfolios are noticeably less volatile.

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Past performance is not a guarantee of future results. Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds.

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