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COROMANDEL WEALTH MANAGEMENT

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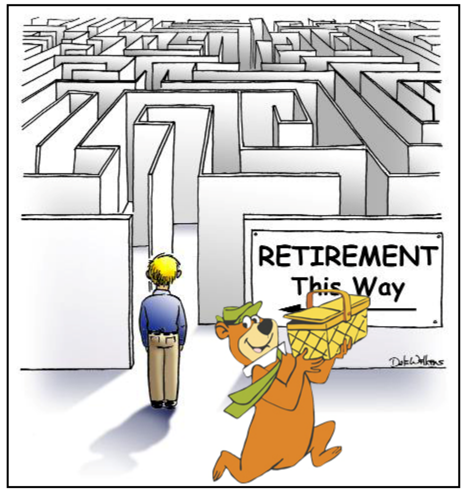
# Don't Ignore Investing's Only "Free Lunch"

*"Diversification is the only 'free lunch'."*

*-- Harry Markowitz, Nobel Prize-winning economist*

*Navigating the Retirement Maze*




In the course of my work with prospective clients, I review their existing portfolios and give them an assessment of how well it fits their retirement goals. A trend I've recently noticed is that investors are beginning to understand the importance of low fees to performance, as evidenced by the growing use of index funds. In fact, Morningstar, an investment research firm, reported that as of 2012, 26 percent of all the assets in open-end mutual funds and exchange traded funds (ETFs) were invested in passively managed index funds, up from only 12 percent a decade ago.

I find this encouraging. However, I often see lacking two other attributes that help improve portfolio performance. The first is buying asset classes when they are historically cheap. I'll cover this topic in next month's column. This month, I want to address what I consider to be the most important, and usually overlooked, attribute of well designed portfolios: diversification.

### Large losses are a drag

There is a brutal math reality associated with investment large losses, which is that it takes a greater gain to break even. Your portfolio lost 33 percent last year? You'll now need to make 50 percent to get it back to its previous value. Lost 50 percent? Now it's a 100 percent gain to break even. Investment professionals call this "volatility drag". Most investors call it: "I'm never investing in stocks/bonds/anything ever again!"

One reason for diversifying your investments is that no one can accurately predict which asset classes will outperform over a given time frame. If you happen to guess correctly, such as owning a NASDAQ 100 index fund in 2013, then you're a winner (up 21 percent year to date). Choose wrong, though, such as the same fund circa 2008 (down 40 percent that year), and your portfolio takes a beating. Most investors would prefer that their investments not exhibit such extreme swings, particularly on the loss side.

One way to do this is to spread your investments across different asset classes, ensuring that all of your metaphorical retirement eggs aren't in one basket. But in order to reduce portfolio volatility, and thus the risk of large losses, those baskets need to be what investment professionals refer to as "uncorrelated."

### Assets that zig when others zag

An index fund provides one level of risk reduction by holding a large number of different stocks or bonds. However, the holdings within the fund are typically in the same asset class (e.g., large cap stocks), and usually rise or fall at the same time, meaning that the fund itself will exhibit similarly extreme swings. Take a look at a yearly graph of the S&P 500 index, the basis for many index funds, and you'll see what I mean.

Clearly, you need to own more than one index fund. But holding a collection of seemingly different funds – such as U.S. large, medium, and small cap – doesn't necessarily mean that your portfolio is well diversified. Stocks in different categories can move surprisingly in lockstep, meaning that they are highly correlated. Thus, a portfolio consisting of only stock funds may not be much less volatile than a single index fund.

The solution is to divide your holdings among asset classes that exhibit low correlation to one another. Examples of asset classes with low correlation to stocks include bonds, commodities, real estate, precious metals, timber, and emerging markets. In my practice, I use specialized software to create and manage diversified portfolios for clients. Fortunately, there are some free tools for this available on the Internet, such as the calculator on InvestSpy.com.

For those whose eyes glaze over when they hear the word "correlation", I can suggest several approaches. Financial magazines and newsletters often have articles about constructing diversified portfolios that can provide some guidance. Also, even though it goes against the DIY approach of "cheap index funds", there are some relatively low-fee target date and balanced funds that do an admirable job of this. Morningstar does an annual review of target date fund families which is available for free on their Web site.

**The value of peace of mind**

While some investors are OK with the do-it-yourself approach, most people just want to know that their retirement savings are safely and profitably invested. If you're not comfortable with DIY, consider some of the lower-fee managed funds mentioned above, or seek out investment managers with reasonable fees. While difficult to put a dollar figure on it, not stressing out over your investments clearly has value. Just make sure that you're getting good value for your money.

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