M Financial Wealth Management™

M WEALTH PERSPECTIVE

July 2009

Diversification in an Uncertain Age

M Wealth provides Member Firms with exceptional fee-based wealth management solutions for their clients.

To help Member Firms grow their wealth management businesses, M Wealth offers everything from value-added wealth services to turnkey asset management and investment consulting.

by Andrew Brigham

It is fashionable of late to claim that in this economic crisis, diversification, a central tenet of investing, failed. This recession has been global and characterized by the threat of deflationary downward pricing. In such an environment, almost all assets act as one and tumble in unison. There is a growing chorus of voices proclaiming that things have changed; we are in a new economic era. How can we continue to trust the archaic concept of diversification in this uncertain age?

The ultimate investment cliché is that diversification is the only "free lunch" in investing; meaning that you are compensated for something without taking additional risk. In fact, diversification famously reduces risk (volatility) allowing a portfolio to compound at a higher rate. Einstein once quipped that "compound interest" is humanity's greatest invention. Compound returns represent how money grows and sometimes are referred to as geometric returns. When comparing two portfolios with identical average returns, the one with less volatility (movement around that average or risk), will have a higher compound return. Free lunch!

A well-diversified portfolio contains a mix of stocks (foreign, domestic, large, small, value and growth), bonds and real assets such as commodities, real estate and inflation protected fixed income. The goal of portfolio construction is to combine assets that have long term return expectations but which react differently to changes in the economy. The measurement used to compare these different return patterns is termed correlation. Positive correlation describes two assets that tend to move together while negative correlation describes assets that tend to move in opposite directions. Adding an asset that correlates negatively with other assets can help dampen volatility and increase compound returns.

The threat of deflation buoys the purchasing power of cash and high quality fixed income investments, but wreaks havoc on all other asset classes. In the twelve month period ending March 31, 2009, the S&P North American Natural Resources Index declined 44%, Real Estate Investments Trusts or REITs were down 60% and just about every equity benchmark was down around 40%. Predictably, high quality bonds did the best on a relative basis: the Barclays Government Intermediate Index was up 5.0% and the Barclays Muni 3 Year appreciated 5.6%. The U.S. dollar strengthened as compared to most major currencies, but in general, with assets declining in value and consumers reluctant to spend, the actual purchasing power of cash increased.

Bill Gross, the Chief Investment Officer of Pacific Investment Management Company (PIMCO), outlined the extremely challenging economic times that we are faced with in his June "Investment Outlook" newsletter. His issue, and he is certainly not alone, is with continued US deficit spending. He points out that the U.S. is projecting an annual deficit of nearly $1.5 trillion, or 10% of Gross Domestic Product (GDP), a number not approached since the 1930s. Five more years of deficits that amount to 10% of GDP will quickly raise America's debt-to-GDP to a level greater than 100% and at 100% the interest might amount to 5% or 6% annual output alone. Furthermore,

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this projected deficit does nothing to address the enormous future needs of an aging baby boomer generation.

However, the word "challenging" when used to describe the current economic times, is a euphemism for risky; the dichotomy is that the worse the economy looks, the higher the potential investment return. The best way to efficiently position a portfolio to capture return in this environment is through diversification. Fiscal stimuli and quantitative easing are potentially inflationary; therefore, it makes sense to own real assets or assets that derive their return from inflation. Domestic inflation would erode the value of the US dollar, which argues for international diversification. Continued deficit spending would potentially increase US borrowing costs, which would argue to keep fixed income maturities short. Unanticipated inflation is usually bad for equities in the short term; however, over long periods of time equities are a good inflation hedge. These investment themes are not based on predictions, but on sound investment principles and they continue to be cornerstones of our investment philosophy.

Current security pricing reflects the collective best guess of what the economic future will hold. Based on historical data, we maintain that it is extremely difficult to profit by trying to time the market. Our advice, if nothing material has changed related to long-term goals and objectives, is to stick with your current strategy. A central tenet of the investment philosophy embedded in all M Wealth strategies is that diversification works and is essential to a healthy long-term investment experience.

Andrew Brigham is a sales consultant for M Wealth and contributes periodic research and articles.

For More Information

For more information on the services offered by M Wealth, please contact:

JoNell Hermanson
503.414.7310
jonell.hermanson@mfin.com

Erik Bjorvik
503.414.7656
erik.bjorvik@mfin.com

Luan Dollens
503.414.7544
luan.dollens@mfin.com

Michael Skourtes
503.414.7572
michael.skourtes@mfin.com

Amy Barnwell
503.414.7698
amy.barnwell@mfin.com

Spencer Provow
503.414.7498
spencer.provow@mfin.com

or visit the M Wealth website at:

www.mfinwealth.com

M Financial Wealth Management
1125 NW Couch Street, Suite 900
Portland, OR 97209
800.508.1820
www.mfinwealth.com