

## IS ASSET ALLOCATION OBSOLETE?

It seems that everywhere you look today, you hear about our high-flying stock market. The intense media focus obscures the fact that it is a very “narrow” group of large company growth stocks that are leading this market to new highs. This frenzy, led by the “.com” stocks, is similar to the period in the early 1970’s when the “nifty-fifty” stocks led the market. What does this mean for a patient, long-term investor who is trying to hang in there with a well-diversified portfolio?

We realize that it is not easy for you to talk with friends whose Internet stocks have soared, while your diversified portfolios have lagged. We believe that the majority of an individual’s portfolio should be well diversified over a variety of asset classes – something you have undoubtedly heard from us before. The process of putting uncorrelated asset classes together clearly improves the risk/ return profile of a portfolio. This strategy allows you to participate in whatever asset class is the next leader of the market. Do you realize that over the past 29 years (ending in 1998) small company stocks have outperformed large company stocks in 16 of those years? In that same time period, international stocks have outperformed US large stocks in over half of the years.

A recent study looked at the performance of four asset classes from 1972-1997 (S&P 500, EAFE - international stocks, REIT’s, and Commodities). Over this time period, *every* single combination of asset classes resulted in higher returns and lower risk than *any* of the individual asset classes. ***Unless you can predict the future, diversification works.***

But let’s be honest, there are some problems with diversification. Unfortunately, it works whether you want it to or not! In periods like those we have seen over the past few years, returns have clearly been dragged down by the strategy. ***Diversification is a long-term strategy, but it is being evaluated on a short-term time horizon.***

While we have focused on diversification within various types of stocks, don’t forget to think about your mix of stocks and bonds. Although the world might very well be different now, we still believe that a period like 1973-1974 can happen again. (Large and small cap stocks were both down over 40% during an 18-month bear market.) You can minimize the impact of this kind of event on your wealth through diversification. For most people, risk is perceived as how much they could lose, not simply how volatile an investment is. History shows that the worst thing that you can do is to try to bet on a single asset class. Many people are taking on much more risk than they realize with their concentrated portfolios.

Diversification works.... It lowers your risk and allows you to participate in whatever asset class will be the next leader. If you have a diversified portfolio, you have paid the price for being different; stick around for the rewards