FAKE DIVERSIFICATION, DOES ASSET ALLOCATION WORK?

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"Integrity is the recognition of the fact that you cannot fake your consciousness, just as honesty is the recognition of the fact that you cannot fake existence."
- Ayn Rand, *Atlas Shrugged*

Domestic equities closed down 14.5% on June 29, 2010 from their April 23rd high. That's a significant decline. Of course, advisors tout sophisticated (and very expensive) asset allocation and diversification strategies, supposedly to protect their clients. So, with this recent decline, all of these supposed diversifiers like foreign and emerging market stocks, real estate, corporate and high yield bonds (junk), foreign bonds, inflation protected bonds, commodities, etc. should all be protecting portfolios, correct?

Let's look at how that is working out. The table below shows the price only return (excludes dividends and interest) from the April 23rd, 2010 market high through yesterday's market close for a variety of ETFs and funds that represent these supposed diversifiers.

	Price Return (excludes dividends/interest)
	4/23/10 - 6/29/10
IShares Barclays 7-10 Year Treasuries (IEF)	**7.26%**
Vanguard Total Domestic Equity (VTI)	-14.52%
Vanguard World Equity Ex-US (VEU)	-14.28%
IShares Treasury Inflation Protected ETF (TIP)	2.97%
IShares iBoxx $ Investment Grade Corp. Bond Index Fund (LQD)	2.49%
IShares iBoxx High Yield Corp. Bond Index Fund (HYG)	-3.65%
IShares S&P/Citigroup Int'l Treasury Bond Index Fund (IGOV)	-3.30%
VALIC Company I Intl Govt Bond (VCIFX)	0.00%
IShares JP Morgan USD Emerging Mkt. Bond Index Fund (EMB)	-0.02%
IShares MSCI EAFE Index Fund (EFA)	-17.06%
IShares MSCI Emerging Markets Index Fund (EEM)	-12.75%
IShares Dow Jones U.S. Real Estate Index Fund (IYR)	-10.41%
IShares FTSE EPRA/REIT Developed Real Estate ex U.S. (IFGL)	-12.90%
IShares S&P GSCI Commodity-Indexed Trust (GSG)	-13.34%
IShares COMEX Gold Trust (IAU)	**7.24%**

Hmmm, funny that the only things you could add to your portfolio to *materially* dampen the recent market's decline was 7-10 Year Treasuries, or gold. But gold doesn't pay any interest, costs you money just to hold it and has a 200 year real return of 0% according to Jeremy Siegel in his book *Stocks for the Long Run*.

Last fall when I took over the management of a $25 million portfolio for a non-profit, they were very concerned about our 50% allocation to IEF, the 7-10 Year Treasury ETF. After all, "everyone knew" that interest rates were going to rise (the 10 year treasury was yielding around 3.5% at the time). Indeed, when the market rallied earlier this year, the 10 Year yield rose to almost 4%. That hurt Treasuries but stocks were rallying. But, despite "everyone knowing" interest rates were going to rise, here we sit today with the 10 Year yielding 2.97%, and its appreciation buffering about half of the market's decline. Not a bad diversifier for the 15 basis points it costs. The committee got more comfortable with owning Treasuries of this maturity when I showed them the worst twelve month return for them going back to 1926 was a decline of less than 10%. Contrast this to the other diversifiers.

YOU WOULD THINK PEOPLE WOULD LEARN

What about the really devastating markets of 2008? The differences were even more extreme. (IGOV wasn't available in 2008 which is why I included the Valic International Government Fund.)

	Price Return (excludes dividends/interest)
	2008
IShares Barclays 7-10 Year Treasuries (IEF)	**15.99%**
Vanguard Total Domestic Equity (VTI)	-36.99%
Vanguard World Equity Ex-US (VEU)	-43.43%
IShares Treasury Inflation Protected ETF (TIP)	-2.05%
IShares iBoxx $ Investment Grade Corp. Bond Index Fund (LQD)	0.11%
IShares iBoxx High Yield Corp. Bond Index Fund (HYG)	-17.56%
IShares S&P/Citigroup Int'l Treasury Bond Index Fund (IGOV)	N/A
VALIC Company I Intl Govt Bond (VCIFX)	-0.55%
IShares JP Morgan USD Emerging Mkt. Bond Index Fund (EMB)	-4.30%
IShares MSCI EAFE Index Fund (EFA)	-42.13%
IShares MSCI Emerging Markets Index Fund (EEM)	-49.47%
IShares Dow Jones U.S. Real Estate Index Fund (IYR)	-40.54%
IShares FTSE EPRA/REIT Developed Real Estate ex U.S. (IFGL)	-52.10%
IShares S&P GSCI Commodity-Indexed Trust (GSG)	-45.75%
IShares COMEX Gold Trust (IAU)	5.22%

Unlike the recent decline where some of the expensive "diversifiers" actually did help a tiny bit, most of them made the performance even worse... the exact opposite of what they were supposed to do. Yet, those inexpensive Treasuries protected capital as they should, even tripling the return of gold.

Here's the scam. The basic asset allocation theory that caught on was based on some long term data and showed the value of blending stocks, bonds and cash. In fact, the Brinson, Hood and Beebower study a lot of advisors chant about demonstrated that 90% or more of the variance in returns among large pension plans was explained merely by their allocation to stocks, bonds and cash. Therefore, less than 10% is explained by all these expensive sub-classes. But advisors can charge more if their pie charts look more complicated, touting the supposed value of "non-correlating assets" that tend to correlate a lot when you need them not to the most.

So, advisors have a conflict of interest in this game by making things far more complicated than needed to justify higher fees. And, their friends who manage the expensive products they use to fill all these pie slices have a conflict of interest because they get to charge a lot more in management fees. Even low fee Vanguard charges more than three times the management fee for their World Equity Ex-US ETF (VEU, 25 basis points) versus their Total Domestic Equity ETF (VTI, 7 basis points). Or, check out the HUGE weighting semi-passive fund company DFA suggests to their expensive real estate and foreign funds where they earn double the fees (or more) of other funds they manage. The product vendors and research departments fool advisors to get more product fees and advisors often un-wittingly end up fooling their clients.

To achieve diversification, you don't need to spend a lot of money. I'm in no way implying that I know where markets are going. They ARE ALWAYS uncertain and if anyone tells you otherwise he is either lying to you or lying to himself, and in reality it is probably both. I'm also not even remotely inferring that past performance is indicative of future results. If the economy gets stronger, it is likely that interest rates will rise and bonds will be hurt, but odds are stocks would take that as pretty good news.

You need diversification to protect your portfolio from market shocks, recessions and depressions. Treasuries tend to do well in such environments like this quarter's decline, the decline of 2008, the '87 Crash and even the Great Depression. I don't know if they will do it again but when the markets get scared there does seem to be a flight to safety.

A popular industry speaker and writer, DAVID B. LOEPER is the CEO and founder of Financeware, Inc. in Richmond, VA. He is author of the top selling book Stop the 401(k) Rip-off!, three other books released in 2009 by John Wiley & Sons (Stop the Retirement Rip-off, Stop the Investing Rip-off and The Four Pillars of Retirement Plans) and numerous whitepapers. He has appeared on CNBC and Bloomberg TV, served on the Investment Advisory Committee of the $30 billion Virginia Retirement System, and was chairman of the Advisory Council for the Investment Management Consultants Association (IMCA). Before founding Financeware in 1999 he was Managing Director of Strategic Planning for Wheat First Union. He earned the CIMA® designation (Certified Investment Management Analyst) from Wharton Business School in 1990 in conjunction with IMCA.

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