Investor Insights & Outlook

October 2011 | Vol 10 | Investment Updates

Benefits of Diversification

"Don't put all your eggs in one basket" is a common expression that most people have heard in their lifetime. It means don't risk losing everything by putting all your hard work or money into any one place.

To practice this in the context of investing means diversification—the strategy of holding more than one type of investment, such as stocks, bonds, or cash, in a portfolio to reduce the risk. In addition, an investor can diversify among their stock holdings by buying a combination of large, small, or international stocks, and among their bond holdings by buying short-term and long-term bonds, government bonds, or high- and low-quality bonds.

A diversification strategy reduces risk because stocks, bonds, and cash generally do not react identically in changing economic or market conditions. Diversification does not eliminate the risk of experiencing investment losses; however, by investing in a mix of these investments, investors may be able to insulate their portfolios from major downswings in any one investment.

Over the long run, it is common for a more risky investment (such as stocks) to outperform a less risky diversified portfolio of stocks, bonds, and cash. However, one of the main advantages of diversification is reducing risk, not necessarily increasing return. The benefits of diversification become more apparent over a shorter time period, such as the 2007–2009 banking and credit crisis. Investors who had portfolios composed only of stocks suffered large losses, while those who had bonds or cash in their portfolios experienced less severe fluctuations in value.

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Monthly Market Commentary

September was filled with uncertainty, which continued to weigh both on businesses and investors. The European debt crisis, with its unknown effects and unclear resolution, has troubled the markets, causing increased stock-market volatility and a significant decline in financial-sector stocks. Not even Federal Reserve chairman Ben Bernanke could calm market sentiments with his “twist” plan, announced after an extended two days of discussion at the Federal Open Market Committee meeting. Despite 2011 being the third year of a presidential term, which historically has been good for stocks, the S&P 500 was temporarily in bear market territory as of Oct. 4, with a 20% decline from its most-recent 2011 high.

GDP: Second-quarter GDP growth was revised up to a final reading of 1.3% from 1.0%, driven mainly by export data. A weak dollar, a revival of the manufacturing sector, strong capital goods sales in emerging markets, and powerful agricultural sales have allowed the U.S. economy to trudge along at an anemic rate with strong exports in the first half of 2011.

Employment: Employers added 103,000 jobs in September, led by gains in the professional and business services and health care, sectors, as well as the 45,000 Verizon Communications employees that returned to work. Similar to August, private-sector growth continued to be offset by contractions in the government sector. In order to effectively put a dent in unemployment rates, job growth of about 150,000 is required per month. Unemployment remained flat at 9.1%.

Manufacturing: The ISM Manufacturing Index inched up slightly—indicating that manufacturing was expanding but still very sluggishly. An ongoing concern was the lackluster performance of new orders and backlogs, which hinted at a potential contraction in demand going forward. Durable goods orders, on the other hand, pointed toward a continued moderate uptrend in manufacturing.

Quarter-end insights: The second-quarter of 2011 continued to defy predictions by economists, with the U.S. economy neither collapsing nor breaking out on the upside. In the wake of persisting uncertainty from the European debt crisis and its contagion effects, along with the U.S. budget debacle in August, investors and corporations became more cautious. Investors seeking yield continued to bid up more-defensive portions of Morningstar’s stock investing universe, seeking stocks that provided income in addition to capital gains. Riskier sectors with less good news, including financials, basic materials, and energy, continued to sell at larger discounts than the overall average. Corporations with near all-time-high profit margins and large amounts of cash were still unwilling to spend or hire significantly given the economic and political uncertainty and the lack of investor confidence. In fact, merger-and-acquisition activities as well as stock buybacks (financed with money borrowed at exceptionally low rates) started to pick up. Consumer spending remained relatively strong, pushing ahead slowly, cautiously and consistently despite setbacks from the lingering effects of earthquakes, hurricanes and budget crises. However, consumers were selective with what they purchased and consistently punished businesses that raised prices too quickly. Gasoline demand in the U.S. declined for three quarters in a row, corresponding closely with the recent acceleration in gas prices. Auto sales and apparel sales were the same, as price hikes from Japan’s supply-chain issues (for autos) and increased cotton prices (for apparel) caused sales to fall. Netflix saw its stock price drop following a pricing change. With regard to inflation, Morningstar economists believe that a slower world economy and a resolution of the Libyan situation should help drive oil prices (the key driver of high inflation) lower in the months ahead. Food prices should also begin to fall as crops are harvested and some of the dismal weather conditions around the world abate. A resumption of Japanese auto shipments should also help drive auto prices lower in the months ahead.

Destination Correlation

"Correlation" and "correlated assets" are mainstay expressions in the jargon of investors and financial professionals, and while the concept of correlation can be confusing to novice investors, a quick explanation can clarify why correlation is a key factor in portfolio construction.

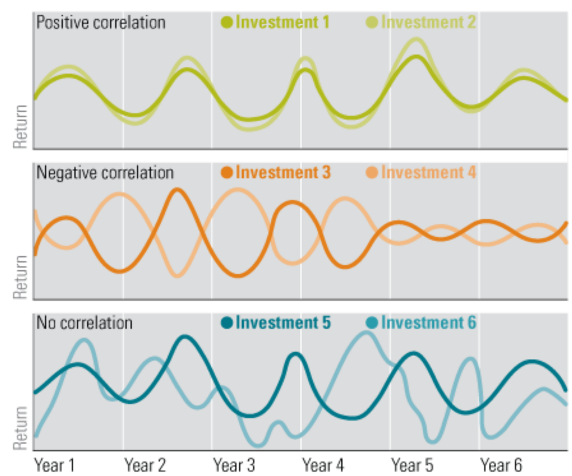
Let’s say you or your financial advisor are trying to choose two investments in the construction of a portfolio. Would you prefer investments that are similar (move in the same direction) or investments that are dissimilar? Think about it this way: If you are going on vacation to an unknown island, what type of clothes will you put in your suitcase? If you only take summer clothes and the island nights turn out to be cold, or if you only bring winter clothes and the climate is tropical, your vacation will probably end in tears. It’s the same with investing: You're better off diversifying than putting all your money in similar investments.

In order to create a truly diversified portfolio, the investments in the portfolio have to compensate for each other’s shortcomings. If investment A declines in value, ideally you would want investment B to increase in value, or at least decline less than investment A. In order to achieve this, you need two investments that behave differently, meaning they have a low correlation.

Correlation is a statistical measure designed to quantify the interrelationship of two investments (again, investment A and investment B). By taking into account the characteristics of the two investments, a mathematical formula calculates a number between –1.00 and +1.00. This number is called the correlation coefficient. If this coefficient is negative (for example, –0.81), we say the two asset classes are negatively correlated. This simply means they tend to move in different directions: if asset class A declines in value, asset class B is likely to increase in value, and vice versa. If the correlation coefficient is positive (for example, +0.34), the two asset classes tend to move in the same direction: they are positively correlated. A correlation coefficient of zero means the asset classes are completely uncorrelated; their movements in relation to one another are random.

Adding investments with low correlation to a portfolio can soften the impact of market swings because the investments do not all react to economic and market conditions in the same manner. For example, building a portfolio with large, small and international stocks would probably not be such a good idea because stocks are generally highly correlated to one another—if large stocks go down, the other stock categories will probably go down, too. The same logic applies to a portfolio with only bonds. However, combining stocks and bonds in a portfolio could provide a significant diversification benefit because these two types of investments do not tend to move together (they have a low correlation).

Various Levels of Correlation



Past performance is no guarantee of future results. Diversification does not eliminate the risk of investment losses. Investment returns shown and correlation numbers mentioned in the text are based on hypothetical data. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

Simple Steps for Late Savers

The sooner you start putting aside money for retirement, the more you might have once that highly anticipated day arrives. Saving for college tuition, purchasing a new home, unforeseen medical expenses, or life's other necessities, surprises, or even enjoyments can cause investors to postpone saving. Starting the retirement planning process late in one's life can be daunting, but it is by no means impossible.

Crunch the Numbers: The first step to getting back on track is to put together a budget—this will force you to focus on your financial situation and can serve as a roadmap to success. Once you have outlined all of your expenses, simply subtract the total from your net income. The result will give you a clear indication of how much you can potentially save, and also help you identify areas in which you may be spending too much.

Cut Any Unnecessary Expenses: There are essential expenses that cannot be eliminated: food, electricity, etc. However, most people can identify some areas, like entertainment, that are not vital to one's existence and can be cut back on. The more areas that you can trim will lead to more money that can be earmarked for retirement.

Take Advantage of Catch-up Contributions: Catch-up contribution limits allow investors age 50 and above to increase their contribution. For example, they can make an extra contribution of $5,500 to their 401(k) in 2011, equating to a maximum contribution of $22,000. IRA catch-ups are $1,000 in 2011, leading to a maximum contribution of $6,000.

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