As we look back to 2000, we have seen two major corrections and a near meltdown of our financial system. Many of us have experienced what we are now calling "the lost decade." From January 1, 2000 to 2011, the S&P 500 returned only 0.55% a year,[1] certainly not enough to reach any long term goals. Many of us have heard that asset allocation is the solution to our investment risk woes. Yet, 2007 to 2009 opened up our eyes to the fact that risk diversification may actually be a different process than asset class diversification. It's an important distinction.

In a presentation by Ashish Tiwari at PIMCO's annual due diligence meeting last month, PIMCO raised the point that it is clearly possible that our understanding of diversification needs to be adjusted.[2] They presented data from the Common-fund Study of endowments[3] that illustrated a blended model of all college endowments[4] greater than 1 billion dollars. On average these portfolios were invested in 12 separate asset classes. Of those asset classes only 28% were invested in domestic and international equity positions. This asset allocation paints a picture of what we would usually believe is a very diversified portfolio. Yet during the market meltdown, even this allocation performed below expectations. Why? Their research pointed out that the major risk factor that all of these assets shared was a high correlation to equities; when the market went down, so did most of these assets. This illustrates the point that asset class diversification does not always act as a diversifier of risk.

Was the decade really lost, and is traditional asset allocation no longer useful? We start with the first question.

When we think about the markets in general, we often make reference to the S&P 500. That is the most often used market index. Few actually know that although the S&P 500 represents the 500 largest companies in the US and a major percentage of all of the US equity markets, it is a capital weighted index. That means that each stock is owned in proportion to its market weighting. Today, an S&P index would hold Apple as its largest position. Back in 2000, Microsoft would have been the largest holding, and Apple would represent about 1/20 the position that Microsoft would have. Since that time, Microsoft has lost about 50% of its value and Apple has grown by 67 times. Consider how much better the return would have been if it owned more of Apple than Microsoft over the last ten years. For that reason, many academics are now stating that although simple indexing is a low cost way of investing, it may not be efficient. Even if we kept it simple and owned an equal weight of all of the S&P 500 stocks during that lost decade, you would have earned 6% per year instead of the 0.55% a year that the standard index returned.

[1] PIMCO 06/22/2012
[2] PIMCO 06/22/2012

[3] 2011 NACUBO-COMMONFUND STUDY OF ENDOWMENT RESULTS AS OF -6/30/2011

[4] The investment goals of endowments are different from other investors and returns experienced by these endowments may not be achieved by investors attempting to duplicate their investment strategy.

With the speed that the markets are moving and the integration of the entire worlds' markets, it seems that it is time to update how we build portfolios. Many people will wisely state that they cannot predict economic trends and therefore they do not. However, refusing to react and respond to current economic trends really means that you are predicting that what happened in the past will happen again, and long term economic statistics will hold out.

It is my belief that historical economic analysis suggests there will be a return to normal returns (10% returns for equities and about 4% return for bonds). It also suggests that the 2000 market crash was a once in a lifetime event, as was the 2008 meltdown, and that the real estate crash that came before was so statistically improbable that none of the rating agencies had models that allowed them to predict a 10% decline in housing, let alone the greater than 30% collapse that occurred. Although statistics suggest we should see a reversion to the mean in investment returns, those same statistics clearly did not "predict" that so many fat tail[5] events would happen in such a short period of time. Historical statistics may not really be a good tool to work with, so far they have significantly under predicted the risks that we have lived through.

Unfortunately it is clear that risks are here. Geopolitical, inflation, recession, rising interest rates are all possible. Yet we need to continue to try to earn enough return to meet our long term goals. How can we have a chance of doing that?

We need to recognize that costs of investments are a drag in a low return environment. To that end, I am looking for ways to lower total costs. It is clear that paying a manager to underperform the market is a poor use of resources. Therefore we are removing managers that do not earn their keep, and we are adding lower cost alternatives to our investment choices. We are also implementing some cost controls in the delivery of information to you that could help us cut our fees and become a greener firm.

We must strive to protect your money from major risks such as inflation and rising interest rates and continue to be more tactical in our investment process. At the same time, we must hedge your investments from risks that might not seem around the corner, but if they do rear their ugly head they will have a significant impact on your returns. Therefore we are spending more time looking at our investment process so that we can try to cover as many risks as we can. I am adding more high level research tools to our systems and spending more time meeting with the best informed minds in the business.

I hope while you all enjoy the summer; we will be spending our time fine tuning our investments so that we can help you stay on the right track to achieve your goals.

[5] This term applies to events that have a low statistical probability

DISCLAIMERS:

The views expressed are not necessarily the opinion of Royal Alliance Associates, Inc., and should not be construed directly or indirectly, as an offer to buy or sell any securities mentioned herein. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed. Individual circumstances vary. Investing is subject to risks including loss of principal invested. No strategy including asset allocation or diversification can assure a profit against loss.

The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

Fixed income investments are subject to various risks including changes in interest rates, credit quality, and other factors. Securities sold or redeemed prior to maturity may be subject to a substantial gain or loss. In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities.

Investors should understand that investing in strategies that are non-correlated to the stock and bond markets are not without risk. There can be no assurance that alternative investments will be profitable and will even outperform asset classes correlated to the stock and bond markets.

This material contains forward looking statements and projections. There are no guarantees that these results will be achieved. Past performance cannot guarantee future results.

Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs and expenses. Past performance is not a guarantee of future results.

The investment goals of endowments are different from other investors and returns experienced by these endowments may not be achieved by investors attempting to duplicate their investment strategy.

Please note that individual situations can vary. Therefore, the information presented in this material should only be relied upon when coordinated with individual professional advice