Investor Insights and Outlook

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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.

Advisor Corner

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A Quick Guide to Leading Economic Indicators

Turn on CNBC on any given day and you are bound to hear about various economic indicators and how they might affect the markets. Although we believe in investing with a long-term horizon, investors should learn what the key economic indicators mean and how they could potentially affect one's portfolio.

Leading indicators are economic indicators that anticipate a change in the direction of the economy and are useful as short-term predictors. Some of these include the returns on the S&P 500 Index, consumer sentiment and expectations, changes in the employment rate, and production levels in the manufacturing sectors.

The unemployment rate represents the percentage of the working population that does not have a job, have actively looked for work in the prior four weeks, or are waiting to be rehired to a job from which they had been temporarily laid off. This figure is seasonally adjusted to reflect the impact of predictable seasonable patterns. In addition to the overall unemployment figure that is often quoted in the media, data on sector specific unemployment figures can be obtained from the U.S. Bureau of Labor Statistics. For example, in December 2010, there were gains of 12,000 retail jobs while the construction sector lost 16,000 jobs. These figures can be important for investors who wish to invest in sector-specific ETFs, or are looking to increase their portfolio exposure to a specific sector.

Average workweek hours looks at the productivity of the workforce. In the past few quarters, statistics have shown that companies have been cutting costs by getting their existing employees to work longer hours, instead of rehiring laid off workers. In addition, the U.S. Bureau of Labor Statistics provides quarterly statistics on output per hour and productivity. Typically, in an economic recovery, real wages increase first, followed by hours worked, and finally employment. Given that there are only so many techniques that companies can use to increase productivity out of workers, further increases in production will eventually result in an increase in employment. This indicator is a good gauge for overall business confidence sentiment.

The University of Michigan Consumer Sentiment Index is created using results from approximately 500 telephone interviews conducted each month. The index is used to forecast spending behavior and economic expectations of consumers, and consumer attitudes on savings, spending, and the business climate. It is frequently cited that consumer spending accounts for about 70% of the GDP in the United States and thus, is an important indicator especially if you are heavily invested in the consumer cyclical sector, in areas like the restaurant, retail, and travel industry.

Both the Chicago Purchasing Managers Index (PMI) and the Institute for Supply Management Index (ISM) look at economic activity in the manufacturing sector based on factors such as production, inventories, new orders, and exports and imports. These statistics are particularly important to investors who wish to seek exposure to the industrials or basic material sectors. However, investors should also take note that manufacturing activity increases because of increased consumer demand, and has been a shrinking portion of our GDP, as compared to the services sector.

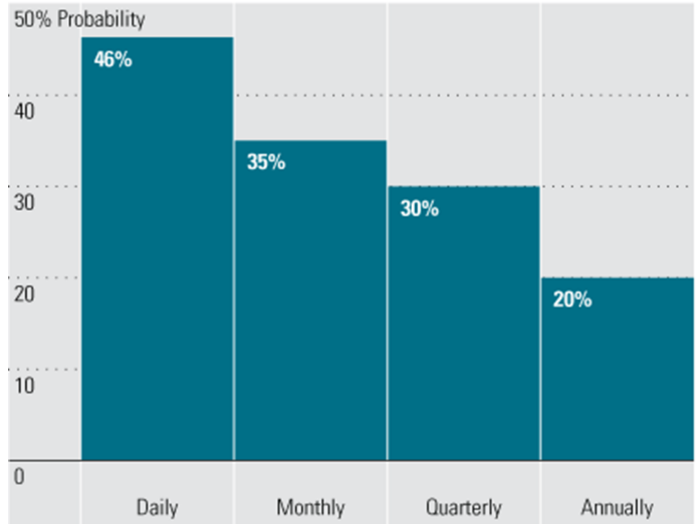
The returns on the S&P 500 Index are also regarded as a leading economic indicator. This index includes 500 of the largest publicly listed companies in the U.S., comprising 75% of all U.S. equities. It is considered a leading indicator because changes in stock prices might reflect investor's expectations for the future of the economy.

Past performance is not indicative of future results. Returns and principal invested in stocks are not guaranteed. Sector investments are narrowly focused investments that typically exhibit higher volatility than the market in general.

Short-Term Focus

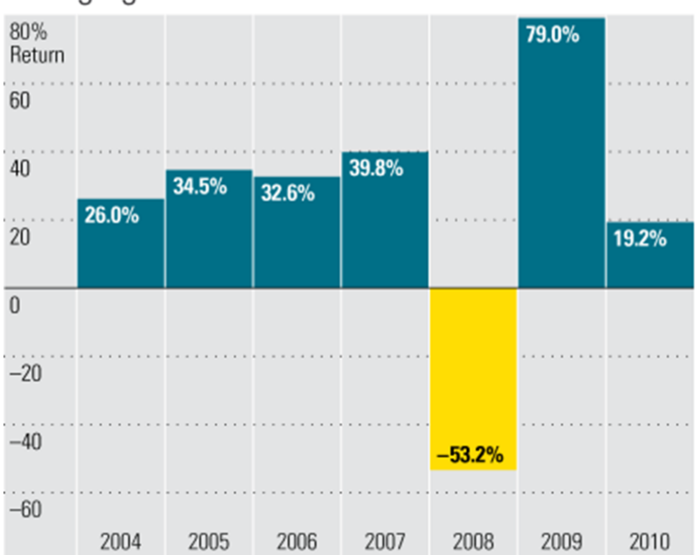
"Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

Historical performance of emerging-market stocks 2004–2010



Source: Emerging-market stocks are represented by the Morgan Stanley Capital International Emerging Markets Index. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. Emerging-market investments are more risky than investments in developed markets.

Overconfidence: False Perception

Consider the performance of emerging-market stocks from 2004 to 2010. For the first four years, stocks in these regions produced impressive returns. Based on this stellar track record, a typical investor may expect more of the same. Well, 2008 was quite dismal for emerging-market investors, as they lost more than half of their investment— 53.2%. In 2009, however, emerging markets rebounded, producing a return of 79.0%. In 2010, emerging-market returns were still positive, but down to 19.2%. When investing, investors must consider the possibility of another year like 2008 in the future. Strong positive returns may be enough to create overconfidence among investors. Investors should avoid overestimating their ability to predict future outcomes and avoid focusing on only the upside potential while dismissing the possibility of poor performance.

What's Up with Gold?

With the run-up on gold during the past few years, many investors have been enamored with its short-term performance and are aching to jump into it. Never mind that gold itself has almost no intrinsic value or that the price is largely determined by what other buyers are willing to pay. The past decade, with market crashes and uncertainty, has caused many investors to flee to the safety of gold, but looking longer term, gold might not be as attractive as it appears. An investment of $100 in stocks beginning in 1980 would have grown to $2,838 by November 2011. That $100 invested in bonds over the same time period would now be $2,186. And if one had invested that $100 in gold in 1980, it would be a measly $333 today.

History has shown that given the volatility of the price of gold, both stocks and bonds outperformed gold in the long run over the past 30 years by providing higher average returns. Stocks and bonds also outperformed gold over a 20-year time period. A starting point of 1980 was chosen because, not unlike today, the price of gold was then at all time highs. With gold fervor rampant, a speculative investment in gold, then, would have resulted in not-so-stellar results today, even with gold's recent performance.

Gold is not without its merits. It has traditionally been considered a good hedge against rising inflation rates, given its ability to preserve purchase power. Gold is also commonly considered a safe haven in times of political and currency crises. As fears of a double-dip recession mount, gold may be considered a tool for diversification, because it generally does not react identically to the same economic or market stimuli as stocks and bonds. A well diversified portfolio of stocks, bonds, and gold has the potential to produce a more appealing risk-and return trade-off over various time periods.

Compound Annual Returns

	1 yr	3 yrs	5 yrs	10 yrs	20 yrs	30 yrs
Stocks	7.8	14.1	–0.2	2.9	8.3	10.8
Bonds	19.4	8.5	9.5	8.4	9.0	10.6
Gold	26.2	28.9	22.0	20.3	8.1	4.9
60/40 portfolio	12.9	13.2	5.3	6.2	9.4	11.4
50/40/10 portfolio	14.7	14.6	7.4	7.9	9.5	10.9
50/30/20 portfolio	15.3	16.5	8.5	9.0	9.4	10.4

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Gold, like any other coin or bullion, is subject to investment risks like perceived scarcity, its quality, current demand, market sentiment, and economic factors. There are material differences between investing in gold versus investing in stocks and bonds. Such differences may include investment objectives, costs and expenses, liquidity, safety, fluctuation of principal or return, insurance, tax features, and any other investment characteristics.

Source: Data as of November 30, 2011. Stocks in this example are represented by the S&P 500® index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds are represented by the 20-year U.S. government bond. Gold is represented by the Federal Reserve (2nd London fix) from 1980-1987 and the Wall Street Journal London P.M. closing price thereafter. Portfolios are rebalanced every 12 months.

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