

Allocation



The effective utilization of investments to preserve or increase their value requires investing in diverse assets that do not all go down at the same time, and that have a high probability of going up in value or produce significant dividends or income. Allocation is the process of maintaining a balance of diverse investments.

Like being in a small boat, having the weight all on one side can result in capsizing. Not good. Even if it is a sail boat and with a strong wind, there is the risk that the wind will stop or change directions. Allocation is the process of regularly redistributing the weight.

Asset allocation requires a zoom lens ability to balance major asset categories and then be able to look at increasing levels of detail within categories and sub-categories. Different investors may use different top-level asset categories. An example might be cash, bonds or fixed income, equities, real estate, tangible assets and debt. Table 1 shows a division of total net worth into asset categories. The categories are each further divided into investment types within each asset and then further divided into strategies and then individual positions.

Table 2 takes Table 1 a step further and shows a specific example. As you can see, the categories within each asset class are slightly different, and the strategies deployed are specific to this example.

Each household needs to decide on the desired distribution of its assets, and the choice of investment types and strategies. Only within that context is it appropriate to select specific investments. While the format may vary dramatically from household to household, it is very important for each household to have on one page a periodic summary showing the relative balance between all assets and within each asset category.

To be a responsible money manager, I don't need to know the family's net worth or the details of the family's asset allocation, but I do want to know enough to feel assured that the asset allocation process is being managed and to know how what I manage fits into that total allocation. This document is an effort to help you refine the skills and tools necessary for maintaining your asset allocation. In addition as a part of my service I am happy to help you place your assets into context and develop an asset allocation system that is relatively easy to maintain and provides a big-picture view as well as detailed analysis of how various strategies and positions fit together. Many families deploy a financial planner for this purpose. While that may be helpful, the more you are involved the more you will understand your finances and your system, be able to keep the system current and available, and be able to make better decisions.

Managing asset allocation requires balancing dimensions other than those shown in Tables 1 and 2. For example, you may want to know what accounts hold each position, how specific categories or strategies are divided between different accounts, and the balance between after-tax, IRA and Roth IRA investments. I find Excel pivot tables to be indispensable to having a flexible way of finding specific information, and being able to easily analyze the balance between one's investments on dimensions such as investment type, account, tax status and strategy. The lawyer helping with your estate planning will want to know how your assets divide by ownership, such as what in the wife's name, the husband's name, joint ownership, and in accounts with beneficiary designations. Most people naturally first think of their investments according to the brokerage or account holding the assets. The ability to add or remove different dimensions such as account or tax status helps to give a better balance as to how various investments straddling different accounts might behave under varying market conditions.

An alternative to mutual funds.

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Lee Wenzel
(952) 944-2699
Lee@WenzelAnalytics.com
www.WenzelAnalytics.com

Wenzel Analytics, Inc.
Registered Investment Advisor
8666 Westwind Circle
Eden Prairie, MN 55344

Table 2.

Total Net Worth and Asset Allocation
An Example (Not to Exact Scale)

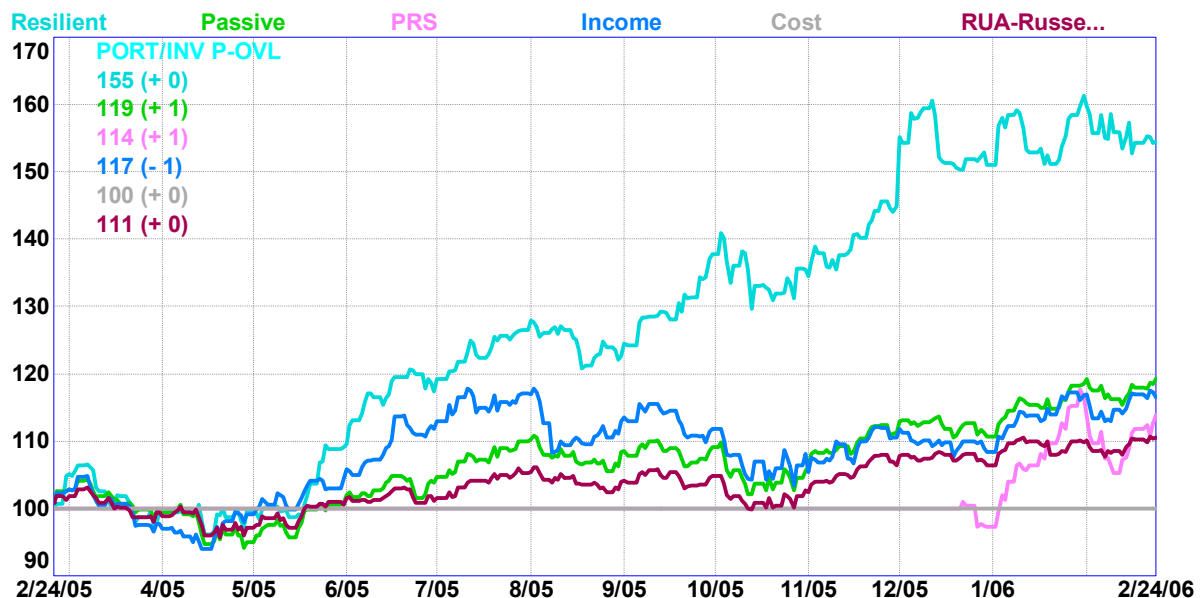
Get Returns?	Personal Property	Investments																
Asset Allocation	Cash	Fixed Income	Passive Equities		Actively Managed Equities										Tangible	Debt		
Within each asset	Vehicles, Furniture, Personal	Currency, Checking, Money-Mkt	Bonds, CDs, Private Loans	Index fund in Qualified 403(b) Plan	Exchange Traded Funds	Stocks							Mutual Funds	Home	Mortgage			
Management					Managed by Wenzel Analytics													
Dollars	\$ 40,000	10,000	20,000	170,000	155,000	207,000							76,000	250,000	(60,000)			
Percentage	Excluded	1%	2%	39%		25%							9%	30%	-7%			
	Excluded	1%	2%	21%	19%	2.8	2.4	3.0	4.6	3.5	1.1	1.9	3.6	2.1	6%	3%	30%	-7%
Strategy	Live comfortably	Meet Expenses	Bonds, Derivatives (Mutual Funds)	Match S&P 500	Match small, mid-cap and emerging markets	Resource Scarcity	Gems	Income	Piotroski Relative Strength	Prudent Speculator	Indiv Pick	Resilient	Shadow	Cyclicals	Resilient to market downturns	Small cap growth	Appreciate	Leverage
Individual Positions				VFINX	IJR MDY EEM						MDRX				AVALX HSGFX RSNRX	BRSIX		

I use the Excel pivot tables and filter functionality to keep track of the current status of all the positions I manage, and to manage appropriate balances such as between strategies for a given account. Whether Excel pivot tables are appropriate for you depends on how familiar you are with Excel, how analytical you are, and how complex are your investments. If your investments consist of personal property, a home and five mutual funds in a 401(k), you obviously don't need an Excel database.

Performance Charts

I use a very affordable portfolio manager program called Fund Manager (www.beiley.com) primarily to show the history and calculate the returns of various accounts, strategies and positions. For each account, strategy or position I like a chart that compares returns to cost and a market benchmark. An example one-year chart taken from the data in Table 2 is shown in Figure 1. The color codes for the chart lines are shown in the labels across the top of the chart. The numbers in the upper left corner show the percentage change for the year, with the numbers in parenthesis rounded for the last day. The Resilient, PRS (Piotroski Relative Strength) and Income lines are for different stock strategies. The PRS strategy was started only recently. The Passive green line covers the passive equities placed in Exchange Traded Funds that I manage. The maroon line for RUA, the Russell 3000, provides a market benchmark. The important capability is to be able to combine and chart any individual position or group of positions and make comparisons either in price change as shown here or in dollars. Different groupings at any point in a hierarchy can be compared on the same chart to any other individual position or grouping. The limitations are in making useful comparisons without getting a chart that is too busy and confusing. Of course it is easier to analyze with a dynamic software tool than with a static piece of paper.

Figure 1.



Pivot Table Functionality

The pivot table functionality of Excel makes it relatively easy to keep a current perspective similar to what is shown in Table 2. In what follows I will paste a few pivot table snapshots from Table 2 data to give an idea of the flexibility and capability available. You are encouraged to explore the data by downloading the same pivot table. You can design the detail and complexity you desire by changing the number of columns and the categories (cardinality) placed within each column.

To create a pivot table you first need to create a database worksheet in Excel. Every column must have a field label. To create the pivot table, mark the data worksheet by clicking on the box above row number 1 and to the left of column A. Then click on Data, Pivot Table and Finish.

A pivot table has three sections. The rows go along the left side, the columns go along the top, and the data goes to the right of the rows and under the columns. For the pivot shown in Table 3 I dragged three fields from the Pivot Table Field list box over to the pivot table and placed them in the rows section. I then dragged the current value field to the data section twice. By right clicking, I Field Settings and changed the values in the first data column to sum from count and modified the format of the numbers. By right clicking on the second data column I again went to Field Settings, clicked on Options, and selected % of Column. Subtotals can be turned on and off in the Field Settings. Using the dropdown list for Assets, the personal property was unchecked since it is a non-investment asset.

Table 3

			Data	
Asset	Inv Type	Portfolio	Value	Percent
Cash	Cash	Cash	10,000	1.2%
Debt	Debt	Debt	-60,000	-7.2%
Fixed Income	Fund-ETF	Income	19,991	2.4%
Mgd Equities	Fund-ETF	Funds	27,431	3.3%
		Ulcer Funds	49,292	5.9%
	Fund-ETF Total		76,722	9.2%
	Stock	Cyclicals	17,119	2.1%
		Gems	19,927	2.4%
		Income	24,472	2.9%
		Original	9,445	1.1%
		Piotroski RS	38,276	4.6%
		PS	28,800	3.5%
		Resilient	16,007	1.9%
Resource Scarcity		23,640	2.8%	
Shadow	29,713	3.6%		
Stock Total		207,398	25.0%	
Mgd Equities Total			284,120	34.2%
Passive Equities	Fund-ETF	Intl	20,704	2.5%
		Passive	305,916	36.8%
Fund-ETF Total		326,620	39.3%	
Passive Equities Total			326,620	39.3%
Tangible	Real Estate	Homestead	250,000	30.1%
Grand Total			830,731	100.0%

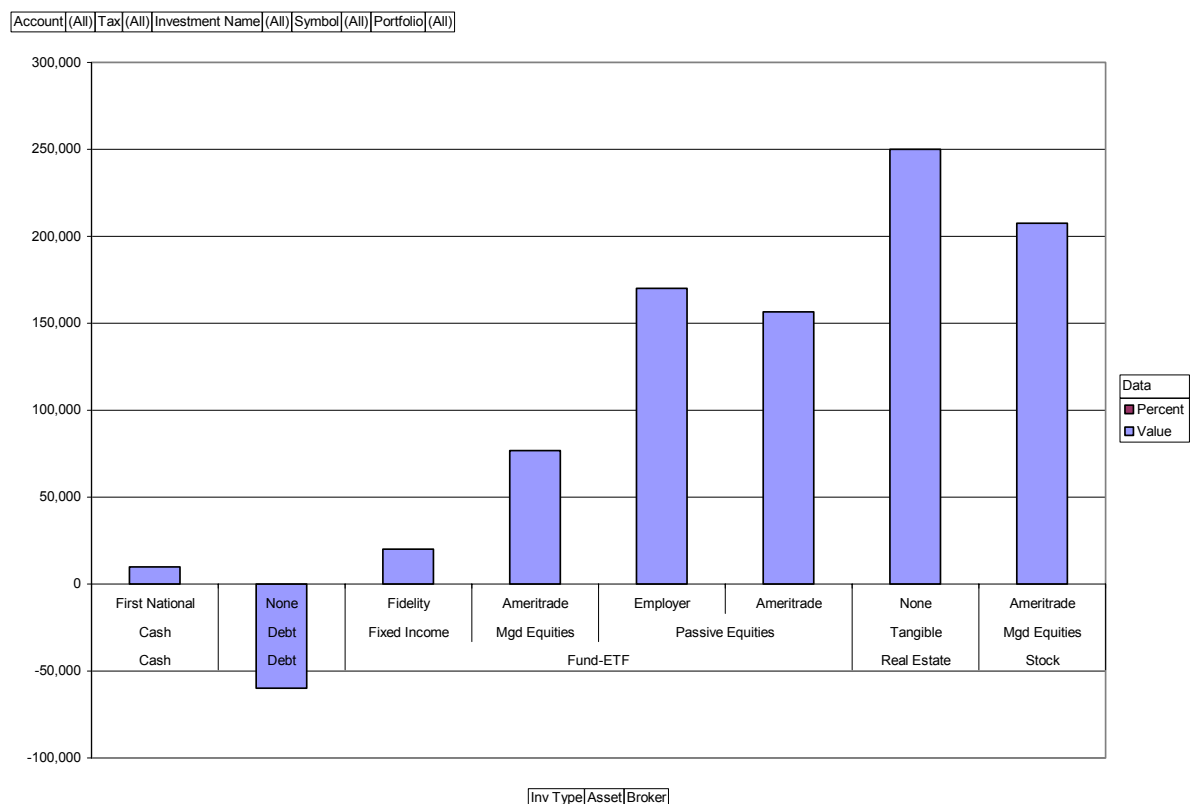
In Table 4 I dragged aside the Portfolio field, brought in the Broker field, and dragged Investment Type to the leftmost column.

Table 4

			Data	
Inv Type	Asset	Broker	Value	Percent
Cash	Cash	First National	10,000	1.2%
Debt	Debt	None	-60,000	-7.2%
Fund-ETF	Fixed Income	Fidelity	19,991	2.4%
	Mgd Equities	Ameritrade	76,722	9.2%
	Passive Equities	Employer	170,000	20.5%
		Ameritrade	156,620	18.9%
Passive Equities Total		326,620	39.3%	
Fund-ETF Total			423,333	51.0%
Real Estate	Tangible	None	250,000	30.1%
Stock	Mgd Equities	Ameritrade	207,398	25.0%
Grand Total			830,731	100.0%

The chart in Figure 2 was created by clicking on the Pivot Chart button of the toolbar. The fields can be moved around on the chart, just like in the pivot table. When you return to the pivot table worksheet, it will reflect any changes made to the chart.

Figure 2



In Table 5 I brought out the tax status field and placed it as a column. The name pivot table comes from being able to drag or pivot the fields from rows to columns or columns to rows.

Table 5

			Tax Data						Total Value	Total %
			403(b)		IRA		Post			
Asset	Inv Type	Broker	Value	%	Value	%	Value	%		
Cash	Cash	First National		0%		0%	10,000	5%	10,000	1%
Debt	Debt	None		0%		0%	-60,000	-27%	-60,000	-7%
Fixed Income	Fund-ETF	Fidelity		0%		0%	19,991	9%	19,991	2%
Mgd Equities	Fund-ETF	Ameritrade		0%	76,722	17%		0%	76,722	9%
	Stock	Ameritrade		0%	207,398	47%		0%	207,398	25%
Passive Equities	Fund-ETF	Employer	170,000	100%		0%		0%	170,000	20%
		Ameritrade		0%	156,620	36%		0%	156,620	19%
Tangible	Real Estate	None		0%		0%	250,000	114%	250,000	30%
Grand Total			170,000	100%	440,740	100%	219,991	100%	830,731	100%

Table 6 shows the same data as Table 5 with the tax field dragged to the rows.

Table 6

				Data	
Tax	Asset	Inv Type	Broker	Value	Percent
403(b)	Passive Equities	Fund-ETF	Employer	170,000	20%
IRA	Mgd Equities	Fund-ETF	Ameritrade	76,722	9%
		Stock	Ameritrade	207,398	25%
	Passive Equities	Fund-ETF	Ameritrade	156,620	19%
IRA Total				440,740	53%
Post	Cash	Cash	First National	10,000	1%
	Debt	Debt	None	-60,000	-7%
	Fixed Income	Fund-ETF	Fidelity	19,991	2%
	Tangible	Real Estate	None	250,000	30%
Post Total				219,991	26%
Grand Total				830,731	100%

In Table 7 I have selected only stocks and show the individual positions.

Table 7

				Data		
Inv Type	Portfolio	Symbol	Investment Name	Value	Percent	
Stock	Cyclicals	CAT	Caterpillar	2,908	1.4%	
		GT	Goodyear Tire & Rubber	2,183	1.1%	
		HPQ	Hewlett Packard	3,202	1.5%	
		JCI	Johnson Controls	2,760	1.3%	
		MOT	Motorola, Inc.	3,145	1.5%	
		PD	Phelps Dodge Corp	2,921	1.4%	
	Cyclicals Total				17,119	8.3%
	Gems	DMLP	Dorchester Minerals L.P.	4,367	2.1%	
		MTA	Mata, Hungarian Telecom. (ADR	3,615	1.7%	
		NGS	Natural Gas Services Group, In	8,392	4.0%	
		RUBO	Rubio's Restaurants, Inc.	3,553	1.7%	
	Gems Total				19,927	9.6%
	Income	LTC	Ltc Properties Inc	5,352	2.6%	
		LXP	Lexington Corporate Prop	4,284	2.1%	
		NNN	Commercial Net Lease Rty	5,281	2.5%	
		SNH	Seniorhousing Prprtys Tr	4,344	2.1%	
		UBA	Urstadt Biddle Properties	5,211	2.5%	
	Income Total				24,472	11.8%
	Original	MDRX	Allscripts Healthcare Solutions	9,445	4.6%	
	Original Total				9,445	4.6%
	Piotroski RS	SUN	Sunoco, Inc.	3,118	1.5%	
		ABIX	Abatix Corp.	3,975	1.9%	
		BGC	General Cable Corp.	4,765	2.3%	
		BLD	Baldwin Technology Co.	4,264	2.1%	
		GI	Giant Industries, Inc.	4,306	2.1%	
		GNSY	Genesys S.A. (ADR)	2,520	1.2%	
		PBR	Petroleo Brasileiro S.A. (ADR)	4,120	2.0%	
PTRY		Pantry, Inc., The	4,094	2.0%		
SPTN		Spartan Stores, Inc.	3,636	1.8%		
TSO		Tesoro Corporation	3,478	1.7%		
Piotroski RS Total				38,276	18.5%	
PS	ADCT	ADC Telecom	9,303	4.5%		
	HOV	Hovnavian	4,755	2.3%		
	KLIC	Kulicke&Soffa	4,588	2.2%		

Inv Type	Portfolio	Symbol	Investment Name	Data	
				Value	Percent
		SPF	Standard Pac	3,442	1.7%
		TER	Teradyne	3,400	1.6%
		VSH	Vishay	3,312	1.6%
	PS Total			28,800	13.9%
	Resilient	ASX	Advanced Semiconductor Enginee	3,191	1.5%
		EOC	Empresa Nacional de Electricid	6,392	3.1%
		LMS	Lamson & Sessions Co., The	2,620	1.3%
		PBT	Permian Basin Royalty Trust	3,804	1.8%
	Resilient Total			16,007	7.7%
	Resource Scarcity	ARLP	Alliance Resource Partners LP	3,762	1.8%
		FDG	Fording Canadian Coal Trust	6,147	3.0%
		MEE	Massey Energy Co	3,888	1.9%
		PCH	Potlatch Corp	3,725	1.8%
		VLO	Valero Energy Corp	2,248	1.1%
		WLB	Westmoreland Coal Co	3,870	1.9%
	Resource Scarcity Total			23,640	11.4%
	Shadow	MCX	MC Shipping Inc.	5,423	2.6%
		MGPI	MGP Ingredients, Inc.	6,895	3.3%
		MIND	Mitcham Industries, Inc.	2,472	1.2%
		PTA	Penn Treaty American Corporati	4,446	2.1%
		SGDE	Sportsman's Guide, Inc., The	5,224	2.5%
		TTIL	TTI Team Telecom International	5,253	2.5%
	Shadow Total			29,713	14.3%
Grand Total				207,398	100.0%

Hopefully, these different views of the data do not have you totally confused and you will have some idea how easy it is to dynamically analyze your assets by simply dragging field headings and then make the appropriate changes to balance your investments.

Pivot tables enable you to analyze your assets by any level of overview or detail that you might find useful. You can look at subtotals and proportions in any combination or sequence. Below is a list of column headings (also called fields or dimensions) that you might want to consider. The Use column of the table refers to dimensions that I personally use in managing my personal and clients' investments.

A template of possible values to correspond to the dimensions given in Table 8 is available as an Excel file from my web site.

Table 8. Possible Dimensions

Column Heading	Use	Description
Investment		Separate investment assets giving a return from assets used in lifestyle.
Active/Passive		Active investments are individually selected by someone, while passive investments have an automated selection process such as index funds or exchange traded funds.
Managed By		A money manager manages the selection of stocks within a mutual fund. Wenzel Analytics may serve as a manager. Different family members may have responsibility to manage different assets.
Asset Class	x	Primary asset allocation categories such as cash, fixed income, equities, tangible things (commodities and collectibles), debt
Asset Sub-type	x	The breakdown of each asset type, i.e. equity might be divided into stocks, real estate, mutual funds, and index or exchange traded funds.
Issuer/Geography		Under stocks this might be domestic vs ADR, under bonds it might be municipals, US Treasuries and corporate.
Strategy	x	Under stocks this would be the screen or criteria which characterized the stock selection.
Style		Traditionally mutual funds are categories into styles by value/growth and market cap. I find strategy to be more relevant for diversification.
Liquidity		What is the time-frame for this investment? Is there a penalty or legal constraint for an earlier liquidation?
Target Date		Do you have a date to end the holding period? If it is a credit card loan at 0% interest being used to buy stocks, when does the 0% rate end?
Tax Status	x	After-tax, qualified (IRA, SEP or 401k), Roth IRA, trust
Owner	x	Husband, wife, joint, child, trust, etc.
Held At	x	Bank, brokerage or physical location of assets.
Account #	x	Account number.
Managed By		Who is looking after these assets and making buy/sell decisions?
Designated Purpose		Is there a designated purpose for this asset, such as college, retirement, long-term care, heirs, charity?
Symbol	x	What is the stock symbol or other abbreviation?
Item Name	x	Name of the asset, such as the name of the stock or mutual fund.
Units	x	How many units of shares are owned?
Price	x	For stocks and funds, this field usually contains a lookup function that automatically brings in daily prices.
Value	x	Price multiplied by units, or manually entered periodically such as for a homestead.
Source		What led to your buying this asset? Does this source have a good track record or a poor track record?
Action	x	This is a field for noting required action, such as watch, sell or a stop.
Target Price		Do you have a target price for this asset that you are waiting for or would prompt a sale?
Date Acquired	x	The date acquired is needed for investments that need to be reported on Schedule D.
Date Sold	x	The date sold is needed for investments that need to be reported on Schedule D.
Owned/Sold	x	This field can say Own or Sold automatically as a function of Date Sold. It is useful in separating current positions from a record of historical holdings.
Purchase Price	x	Price paid per unit.
Basis	x	What was paid for this asset?
Sale Price	x	Price received upon sale for each unit.
Sale Value	x	What was it sold for (if sold)?
Gain/Loss	x	What is the current gain or loss on this asset?
Annual Return Last Yr		What was the annual return rate last year?
Annual Return Projected		What rate of return are you expecting from this asset? (optional, of course)
Volatility		How do you rate the volatility or risk level for this asset?
Beta		Statistical measure of volatility relative to the market.
Trial Shares	x	This column is useful if you use the data sheet as a trading worksheet. If you are going to invest \$30,000 in ten stocks, how many shares of each would you buy to spread the dollars evenly?
Trial Cost	x	In the case of purchasing stocks, trial shares multiplied by price plus commissions.

Critique of Standard Allocation Models

References are made to asset allocation determining 91.5% of portfolio performance. Usually this is a misquote and inappropriate application of research by Gary Brinston, Brian Singer and Gilbert Beebower published in *Financial Analysts Journal*, May-June 1991. First, this was found to be an average and does not apply to all cases. Second, the 91.5% (sometimes the figure is given as 93.6%) refers to variation, not a claim that 91.5% of investment returns come from asset allocation. The return due to investment strategy was defined as the return of the portfolio relative to index funds with fixed weights. Averaged over plans, this return will approach zero. The research was based on investments at that time by very large pension plans investing in very different securities and for very different purposes than what characterizes at least my investing today. While allocation is very important, the 91.5% figure is hardly relevant.

A second common misunderstanding has to do with style boxes as commonly found at Morningstar and Value Line as the fundamental dimension for achieving diversification. Large charts such as the one compressed below are intended to convince the reader that since one cannot pick one of these asset styles to consistently be the best, one should balance according to these criteria. (To see a larger chart through 2005 go to www.callan.com/resource/periodic_table/pertbl.pdf.)

Figure 3

Annual Returns for Key Indices (1984–2003)
Ranked in order of performance (Best to Worst)

1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
LB Agg 15.15%	MSCI EAFE 56.14%	MSCI EAFE 69.46%	MSCI EAFE 24.64%	Russell 2000 Value 29.47%	S&P 500 Growth 36.48%	LB Agg 8.96%	Russell 2000 Value 51.18%	Russell 2000 Value 29.15%	MSCI EAFE 32.57%	MSCI EAFE 7.78%	S&P 500 Growth 36.13%	S&P 500 Growth 23.97%	S&P 500 Growth 36.52%	S&P 500 Growth 42.16%	Russell 2000 Growth 43.09%	Russell 2000 Value 22.63%	Russell 2000 Value 14.02%	LB Agg 10.26%	Russell 2000 Growth 48.54%
S&P 500 Value 10.52%	S&P 500 Growth 33.31%	S&P 500 Value 21.67%	S&P 500 Growth 6.55%	MSCI EAFE 28.26%	S&P 500 Index 31.69%	S&P 500 Growth 0.20%	Russell 2000 Value 46.05%	Russell 2000 Value 18.42%	Russell 2000 Value 23.86%	S&P 500 Growth 3.14%	S&P 500 Index 37.58%	S&P 500 Index 22.96%	S&P 500 Index 33.96%	S&P 500 Index 26.58%	S&P 500 Growth 28.23%	LB Agg 11.63%	LB Agg 8.43%	Russell 2000 Value -11.43%	Russell 2000 Value 47.25%
MSCI EAFE 7.41%	S&P 500 Index 31.73%	S&P 500 Index 18.67%	S&P 500 Index 5.23%	Russell 2000 Value 24.99%	S&P 500 Index 26.13%	S&P 500 Index -3.11%	Russell 2000 Value 41.70%	S&P 500 Value 10.52%	S&P 500 Value 18.89%	Russell 2000 Value 3.14%	S&P 500 Value 36.99%	S&P 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	MSCI EAFE 26.96%	S&P 500 Value 6.08%	Russell 2000 Value 2.49%	MSCI EAFE -15.94%	Russell 2000 Value 46.03%
S&P 500 Index 6.27%	Russell 2000 Value 31.04%	LB Agg 15.30%	S&P 500 Value 9.68%	S&P 500 Value 20.16%	Russell 2000 Value 20.16%	S&P 500 Value -6.65%	S&P 500 Value 38.37%	Russell 2000 Value 7.77%	S&P 500 Value 18.61%	S&P 500 Value -0.64%	Russell 2000 Value 31.04%	Russell 2000 Value 21.37%	S&P 500 Value 29.98%	S&P 500 Value 14.69%	Russell 2000 Value 21.26%	Russell 2000 Value -3.02%	Russell 2000 Value -9.23%	Russell 2000 Value -20.48%	MSCI EAFE 36.59%
S&P 500 Growth 2.93%	Russell 2000 Value 31.01%	S&P 500 Growth 14.50%	LB Agg 2.73%	Russell 2000 Value 20.36%	Russell 2000 Value 16.25%	Russell 2000 Value -17.42%	S&P 500 Growth 30.47%	S&P 500 Index 7.62%	Russell 2000 Growth 13.37%	Russell 2000 Value -1.55%	Russell 2000 Value 26.44%	Russell 2000 Value 16.53%	Russell 2000 Value 22.96%	LB Agg 8.70%	S&P 500 Index 21.04%	S&P 500 Index -9.11%	S&P 500 Value -11.71%	S&P 500 Value -20.85%	S&P 500 Value 31.79%
Russell 2000 Value 2.27%	Russell 2000 Growth 30.97%	Russell 2000 Value 7.41%	Russell 2000 Value -7.12%	S&P 500 Index 16.61%	LB Agg 14.53%	Russell 2000 Value -19.50%	S&P 500 Value 22.56%	LB Agg 7.40%	S&P 500 Index 10.08%	LB Agg -1.81%	Russell 2000 Value 25.75%	Russell 2000 Value 11.32%	Russell 2000 Value 12.93%	Russell 2000 Value 1.23%	Russell 2000 Value 12.73%	S&P 500 Value -14.17%	MSCI EAFE -11.89%	S&P 500 Index -11.89%	S&P 500 Index -22.10%
Russell 2000 Value -7.13%	S&P 500 Value 29.68%	Russell 2000 Value 5.69%	Russell 2000 Value -8.76%	S&P 500 Growth 11.95%	Russell 2000 Value 12.43%	Russell 2000 Value -21.77%	LB Agg 16.00%	S&P 500 Growth 5.08%	LB Agg 9.73%	LB Agg -2.44%	LB Agg 16.46%	MSCI EAFE 6.05%	LB Agg 9.64%	Russell 2000 Value -2.55%	LB Agg -0.82%	S&P 500 Growth -22.06%	S&P 500 Growth -12.73%	S&P 500 Growth -23.59%	S&P 500 Growth 25.66%
Russell 2000 Growth -15.84%	LB Agg 22.19%	Russell 2000 Growth 3.59%	Russell 2000 Growth -10.48%	LB Agg 7.69%	MSCI EAFE 10.53%	MSCI EAFE -23.45%	MSCI EAFE 12.14%	MSCI EAFE -12.18%	S&P 500 Growth 1.69%	LB Agg -2.92%	MSCI EAFE 11.21%	LB Agg 3.64%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	Russell 2000 Value -1.49%	Russell 2000 Value -22.43%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	LB Agg 4.10%

“The Periodic Table of Investment Returns (above) produced by Callan Associates conveys an enormous amount of information. Above all, the table shows that the case for diversification, across investment styles (growth vs. value), capitalization (large vs. small) and equity markets (U.S. vs. international) is strong.”

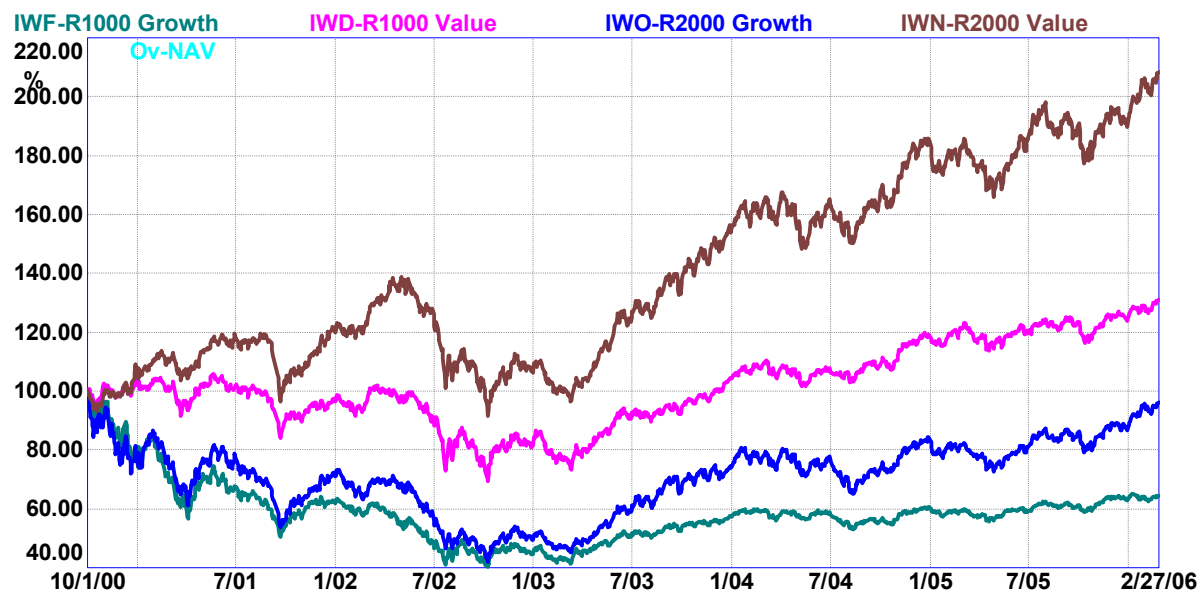
It is relatively easy to show disorder or chaos in data, even when there are patterns within the data. For example, a portfolio with 65% winning stocks that average up twice as much in dollar value as the losing stocks go down will produce phenomenal returns, while looking at the individual winners and losers could show a disheartening picture.

The above chart mixes dimensions. If there is to be a geographical dimension it could comprise the Midwest, the East Coast, the West Coast, the South, Europe, Asia and Latin America. If one is going to diversify by market cap or by value/growth, those are entirely different and overlapping dimensions.

In Figure 4 we find a pattern in what looks like chaos in Figure 3. We divide stocks into a standard two by two matrix of large cap and small cap, value and growth. (One often sees blends in the middle resulting in a three by three matrix.) We have had ETFs for this cross of two dimensions since

October of 2000, which is long enough to show that the performance is not nearly as unpredictable as “demonstrated” in the Periodic Chart of Figure 3. After two years weighted indexes of large cap stocks were at about 40% of original value, while small cap value was about even and small cap growth was down to about 80% of original value. Instead of looking at the winner for each year it is better to look at the longer-term patterns.

Figure 4



Any such chart as shown in Figure 4 is going to look quite different depending upon the starting and ending dates for the chart.

The primary shortcoming of the large cap/small cap and value/growth approach to style allocation is that it presumes that these criteria are some kind of valid strategy for picking investments. As you can see in Figure 4, all of these correlate (as do stocks and bonds in the current environment). A better way to achieve both performance and diversification is to select specific positions utilizing diverse strategies each with quite different criteria. In my data mining search for predictive screening criteria, market cap is rarely a predictive variable and relative book value (which defines value/growth) is predictive only for certain ranges and in combination with several other variables.

There was a very provocative article entitled “Why well-designed portfolios don’t depend on cap size and style categories” published in the February, 2004, issue of *AAII Journal* (available at www.aaii.com). In it James B. Cloonan, chairperson of AAII, states “I believe that over the long run, there is no significant risk reduction benefit from diversifying across different investment style categories or market-cap size categories.” He goes on to state “Using the Russell indexes (for both size and style) for the past 23 years, I compared large-cap performance to small-cap performance and growth stocks to value stocks, and found that the risk level was not reduced by diversifying across either the Russell market cap or style groupings, or both. This is basically because the range of correlations within each group is just as wide as the range between the groups.” In addition, he makes the point that “Most of the studies that compare the performance of small-cap stocks and large-cap stocks effectively leave out the performance of the micro-cap and nano-cap subgroups, as well as much of the small-cap universe.”

One of my challenges is to effectively compete with the likes of a Goldman Sachs spending 500 million a year on research and making three-fourths of its profit, not from client accounts, but from in-house trading. One strategy is to buy three and five thousand dollar positions in smaller stocks with liquidity too low for a large institutional investor to invest a hundred million dollars, even if titrating it out over time.

So you might wonder why most of the investment world is organized around the size and style dimensions. My own speculation is that while it is not particularly relevant for the welfare of the individual investor, it is very relevant for the financial well-being of financial planners, advisors and mutual funds. In addition to a financial planning fee, many financial planners and advisors charge a wrap fee of approximately one percent to manage an account, do the asset allocation by size and style, and pick funds that correspond to that allocation. In addition, most advisors have significant revenue from the fund as a marketing fee. To enable this selection process, mutual funds are put in the size and style boxes. If a particular size or style is out of favor with the market, the poor money manager within those funds is in a box. The losing fund is terminated, the investors lose their tax losses, and the investments are placed in another fund within the same family of funds. Meanwhile the advisor can explain that that is the reason for diversification, or the advisor can blame the fund, assure the client that he or she is now in a better fund, and be untarnished in maintaining the client relationship. A little jaded? Perhaps.

For the equities part of ones portfolio consisting of stocks and stock derivatives such as mutual funds, the place to start is to decide between active and passive investing. In active investing a real person such as myself or a money manager at a mutual fund is selecting stocks. The expectation is to do better than the market average. The passive approach has a computer picking stocks to represent a broad section of the market. It is like throwing darts to get the average. Since costs are lower most passive index funds or exchange traded funds do better than the average mutual fund. Depending upon which part of the market one selects for a passive fund, one is assured of coming close to market performance. Expenses for exchange traded funds are minimal, often in the .2% range, although many investors pay a wrap fee of maybe 1% for an advisor to select the index or exchange traded fund. So passive investing is more defensive against doing worse than the market, while active investing aims to do better than the market. Of course if the market goes down, the passive investor will go down with it. The active investor may have better resilience in down markets, or may be even more subject to downturns in a down market.

I often suggest between a fourth and a third of the equity portion of ones allocation be designated for passive investments. Exchange traded funds are easy and inexpensive to sell if the market is heading down, and easy to buy again when the market is going up since exchange traded funds trade like a stock.