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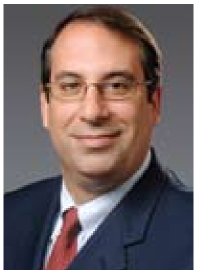
Difficult Investment Environments Prove the Value of Diversification



Enrique Chang
Executive Vice President & Chief Investment Officer

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Challenges still lie ahead for the global economy and capital markets. Governments and central banks are providing liquidity and fiscal stimulus while the private sector is deleveraging. Economic recovery will come, but it probably won't be a sudden bounce.

Our Outlook Remains Cautious

Investors are still facing risks. We are not near the end of this recession yet. We are investing in an environment where the financial system is limping along primarily due to massive government intervention. And we do not see strong signs of a quick recovery once a turning point is reached. Yet despite some short-term pessimism, my overall view on the economy is more sanguine. The markets will recover. And looking ahead to that day, my biggest concern is how investors position their portfolios and future investment plans in anticipation of this recovery, and in light of what has occurred over the past 18 months.

The Recency Effect

In the field of behavioral finance, the "recency effect" describes how investors formulate their expectations and base their decisions by placing the highest weight on what they've recently experienced. In today's environment, with nearly all individuals having suffered losses on their investments—particularly their retirement accounts—my concern is that this recency effect will lead investors in two very different directions that both spell trouble. One direction is to hunker down and hold a portfolio consisting only of very low risk-return investments. The other direction is to conclude the only way to catch up from recent losses is to shift their portfolios to substantial weights in much higher risk-return securities.

This concern also extends beyond individual investor behavior to potentially new legislation or regulatory policies. In some quarters of government, the current debate is focused on "fixing" IRA or 401(k) retirement accounts as if these have been the root cause of today's financial woes. In fact, both these investment vehicles offer substantial benefits to investors in terms of tax deferral and employer matches on contributions.

Diversification: A Proven Investment Strategy

Unfortunately, broad diversification of investments has also come under some criticism. In times when markets are up, diversified portfolios typically don't provide the highest returns relative to an all-equity portfolio—albeit they provide positive returns. However, in a broad bear market such as we are currently in, a diversified investor may look at his losses and question whether diversification "worked" at all.

In fact, broad diversification may be the best approach for achieving a solid risk-adjusted return over the long term. And while investors in diversified portfolios may currently be disappointed with their recent losses, these would have been much larger losses had they not diversified. That kind of performance over the long haul—not the highest gains but not the largest losses—is critical to success for creation of wealth and in achieving long-term investment goals. It is important to note however, that diversification does not assure a profit or protect against a loss in a declining market.

Looking Ahead

Broad diversification, across investment sizes and styles, geographies, and asset classes, remains the very best long-term investment strategy. While the merits of this approach can get lost in times when investor exuberance or pessimism dominates, its wisdom becomes apparent over the long term. If you have not been a disciple of broad diversification, I encourage you to reconsider your investment strategies, especially in light of how well our asset allocation funds have performed.

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