



# The Rewards of Multiple-Asset-Class Investing

by **Roger C. Gibson, CFA, CFP®**

“Let every man divide his money into three parts, and invest a third in land, a third in business, and a third let him keep in reserve.”

— *Talmud*  
*Circa 1200 B.C. – 500 A.D.*

Asset allocation is not a new idea. The Talmud quote above is approximately 2,000 years old. Whoever said it knew something about risk. He also knew something about return. He may have been the world’s first proponent of asset allocation. Today, we talk about asset allocation rather than diversification, but it is really just a new name for a very old and time-tested investment strategy. A more contemporary translation of the advice might read: “Let every investor create a diversified portfolio that allocates one-third to real estate investments, one-third to common stocks, with the remaining one-third allocated to cash equivalents and bonds.”

Is it still a good idea today? Let’s examine the recommendation in more detail. The overall portfolio balance is one-third fixed-income investments and two-thirds equity investments. The one-third allocated to fixed-income mitigates the volatility risk inherent in the two-thirds allocated to equity investments. Diversification across two major forms of equity investing with dissimilar patterns of returns further reduces the

equity risk. The result is a balanced portfolio, tilted toward equities, appropriate for an investor with a longer investment time horizon who is simultaneously concerned about risk and return. It is a remarkably elegant and powerful asset allocation strategy. Imagine trying to develop a one-sentence investment strategy, knowing that a wide variety of investors, most of whom are not yet born, will follow the advice for the next 2,000 years! You would be hard-pressed to come up with something better.

The unknown author of the Talmud quote could not have possibly envisioned today's investment world. Over the past two decades, democracies and free enterprise have replaced many of the world's dictatorships and centrally directed economies. New capital markets are forming, and investment alternatives have proliferated. People from around the world can exchange volumes of information instantaneously via the Internet, virtually without cost. The world has truly gotten smaller and increasingly interconnected as economic events in one part of the world affect markets on the other side of the globe.

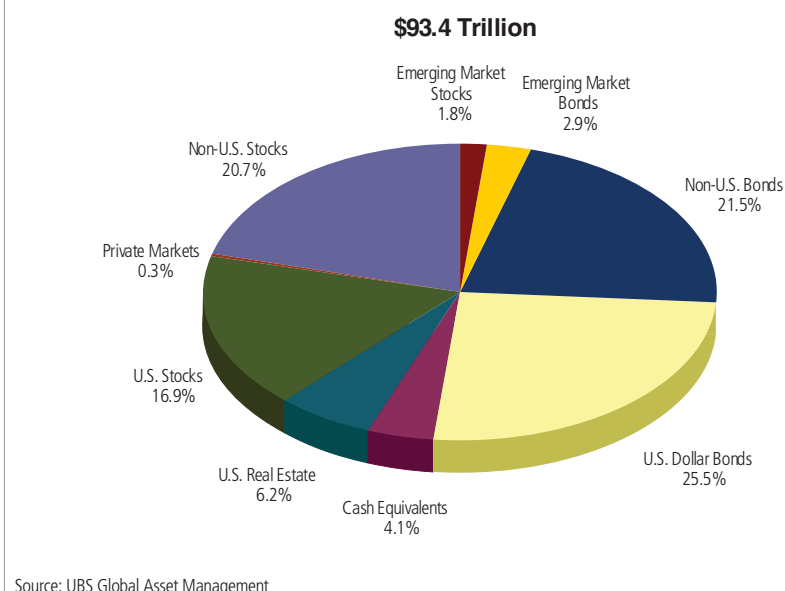
In spite of all of this change, investors are not that different today than they were a hundred years ago. They want high returns, and they do not want to incur risk in securing those returns.

Diversification is a time-honored investment principle. In this article, let's explore the role of multiple-asset-class diversification in giving investors the returns they long for, while mitigating the risks they face. Asset allocation does not guarantee a profit or protect against a loss.

## International Investing

An old adage advises us to "not put all of our eggs in one basket." Although there are obvious advantages to using more than one basket to carry our eggs, the benefits of diversification are more powerful and subtle than this adage suggests.

**EXHIBIT 1** Total Investable Capital Market, December 31, 2005 (Preliminary)



When we construct an investment portfolio using multiple asset classes, we discover that portfolio volatility is less than the weighted average of the volatility levels of its components.<sup>1</sup> This occurs as a result of the dissimilarity in patterns of returns among the components of the portfolio. We will call this advantageous reduction in portfolio volatility the *diversification effect*.

Exhibit 1 shows a pie chart depicting the distribution of the total investable capital market as of December 31, 2005. Why not take diversification to its logical conclusion and design portfolios that use all of these major world asset classes? This would generate more opportunities for the ups and downs of one asset class to partially offset the ups and downs of other asset classes.

Let us begin with interest-generating investments and examine the impact of internationally diversifying a U.S. Bond portfolio. Exhibit 2 graphs the comparative performance over rolling 25-year periods of a 100% U.S. long-term corporate bond portfolio versus portfolios with 10%, 20%, and 30% Non-U.S. Bond allocations. There are nine lines on the chart — one for each 25-year rolling period ending 1997 through 2005.<sup>2</sup> In each case the bond portfolio volatility decreased as the allocation to Non-U.S. Bonds increased from 10% to 30%.

<sup>1</sup> The only exception to this is the rare situation of perfect positive correlation of returns among the investments in the portfolio.

<sup>2</sup> The first 25-year rolling period is from 1973 through 1997.

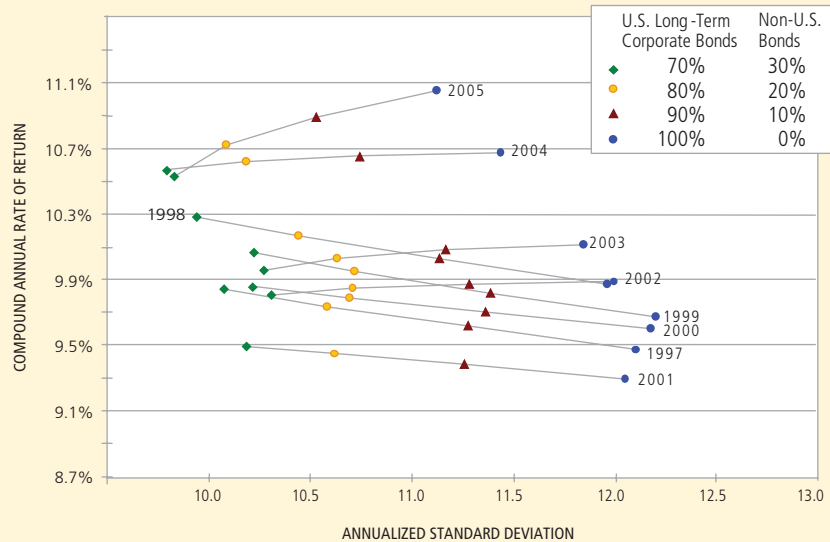
Depending on the specific time period involved, the international diversification sometimes slightly increased and other times slightly decreased the portfolio's compound annual return. Investments in Non-U.S. markets are susceptible to interest rate, currency exchange rate, economic, and political risks.

**Exhibit 3** examines the impact of internationally diversifying a U.S. large company stock portfolio. The return data for Non-U.S. Stocks begins three years earlier than for Non-U.S. Bonds, and we therefore have 12 rolling 25-year periods to examine.<sup>3</sup> Over every 25-year period, portfolio volatility was lower with an allocation of 10% or 20% to Non-U.S. Stocks. And in almost every period, volatility remained lower with an allocation of 30% Non-U.S. Stocks as compared with an all-U.S. large company stock portfolio. As was the case with international bond diversification, in some periods, diversification into Non-U.S. Stocks improved the portfolio's compound return slightly and in other periods the compound return dropped slightly. Although it is worthwhile exploiting the improvements in long-term volatility-adjusted returns made possible with international stock and bond diversification, these benefits are modest compared with those accompanying diversification into other asset classes.

## Multiple-Asset-Class Investing

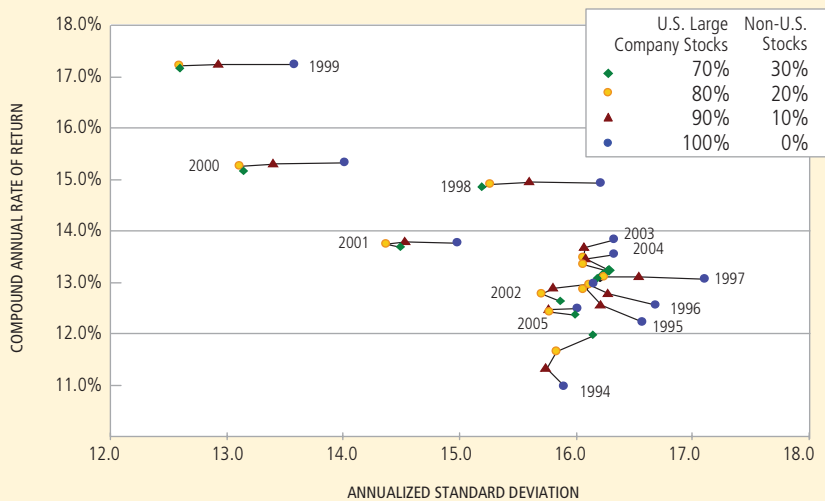
Let's look at multiple-asset-class investing in a broad equity context. The equity side of the portfolio is usually responsible for great portfolio returns when they occur. The equity side of the portfolio is also most often responsible for signifi-

**EXHIBIT 2 International Diversification of a Bond Portfolio**  
Rolling 25-Year Periods Ending December 1997 Through 2005



Source: ©Roger C. Gibson, *Asset Allocation: Balancing Financial Risk*, Third Edition, McGraw-Hill Publishing, New York, NY, 2000. Updated by author, Roger C. Gibson.

**EXHIBIT 3: International Diversification of a Stock Portfolio**  
Rolling 25-Year Periods Ending December 1994 Through 2005



Source: ©Roger C. Gibson, *Asset Allocation: Balancing Financial Risk*, Third Edition, McGraw-Hill Publishing, New York, NY, 2000. Updated by author, Roger C. Gibson.

Standard deviation is an indication of the portfolio's total return volatility. The larger the portfolio's standard deviation, the greater the portfolio's volatility. **Past performance is no guarantee of future results.**

cant losses. **Exhibit 4** shows the performance of 15 different equity portfolios over the time period from 1972 through 2005. The portfolios are intentionally unlabeled in order to conduct a "blindfolded" exercise. Of these 15

<sup>3</sup> The first 25-year rolling period is from 1970 through 1994.

portfolios, four are identified by squares, six are triangles, four are diamonds, and one is a circle. As we move to the right along the graph, portfolio volatility increases. Likewise, the compound annual return increases as we move from bottom to top.

Assume that we have a reliable crystal ball and know with certainty that each one of these portfolios will have the same performance over the next 34 years that it had over the period from 1972 through 2005. Now answer these questions:

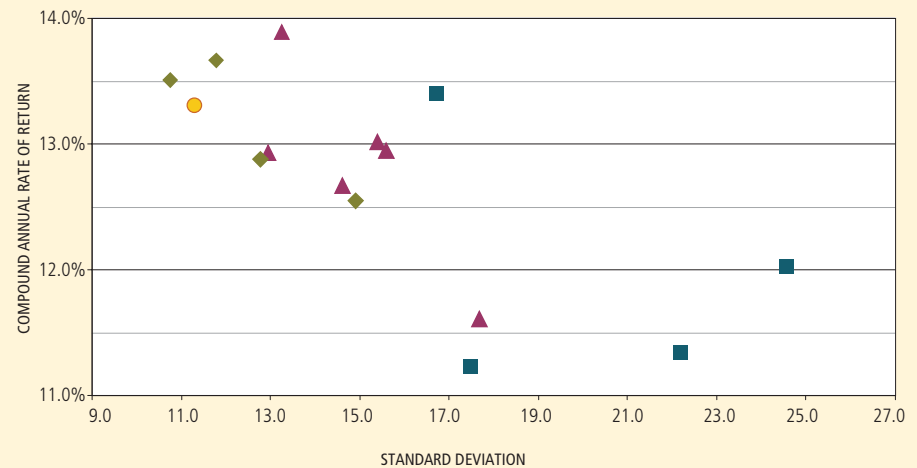
- If you had to choose between owning a randomly chosen portfolio identified by a square or one identified by a triangle, which would you choose: square or triangle?
- If you had to choose between owning a randomly chosen portfolio identified by a triangle or one identified by a diamond, which would you choose?
- If you had to choose between owning a randomly chosen portfolio identified by a diamond or simply owning the circle, which would you choose: diamond or circle?

I have asked this series of questions to my clients and to audiences of people at speaking engagements. The answers are consistent. When given the choice, people prefer the triangles to the squares, the diamonds to the triangles, and the circle to the diamonds.

Now turn to **Exhibit 5**. Each square is a single-asset-class portfolio:

- **“A (U.S. Stocks)”** is a capitalization-weighted total return index of U.S. large company stocks.
- **“B (Non-U.S. Stocks)”** is a total return index of Non-U.S. Stocks from Europe, Australia, Asia, and the Far East. It is an aggregate of 21 individual country indices that collectively represent many of the major Non-U.S. markets of the world.
- **“C (Real Estate Securities)”** is an index that measures the total return of equity real estate investment trusts (REITs) and as such, is a good proxy for the real estate asset class. Changes in real estate values or economic

**EXHIBIT 4: Fifteen Equity Portfolios, 1972 – 2005**



Source: ©Roger C. Gibson, “Asset Allocation and the Rewards of Multiple-Asset-Class Investing,” 1998. Updated by author, Roger C. Gibson.

downturns can have a significant negative effect on issuers in the real estate industry.

- **“D (Commodities)”** is an index that measures the total return of a collateralized futures contract representing a diversified cross section of the major raw and semifinished goods used by producers and consumers. The major components of the index are energy, agricultural products, industrial metals, livestock, and precious metals. The market value of commodity securities may be influenced by many unpredictable factors, including highly volatile commodity prices. Suspension or disruptions of marketing trading in commodities may adversely affect the value of commodity securities.

The triangles represent every possible two-asset-class portfolio that investors can construct using the four single asset classes (A, B, C, and D) as building blocks. Each portfolio is rebalanced annually to maintain an equally weighted allocation between the two asset classes. For example, the triangle AB represents the performance of a portfolio weighted equally between U.S. Stocks and Non-U.S. Stocks.

The diamonds represent every possible three-asset-class portfolio that investors can construct with the four single-asset classes. And the circle is an equally balanced portfolio using all four asset classes.

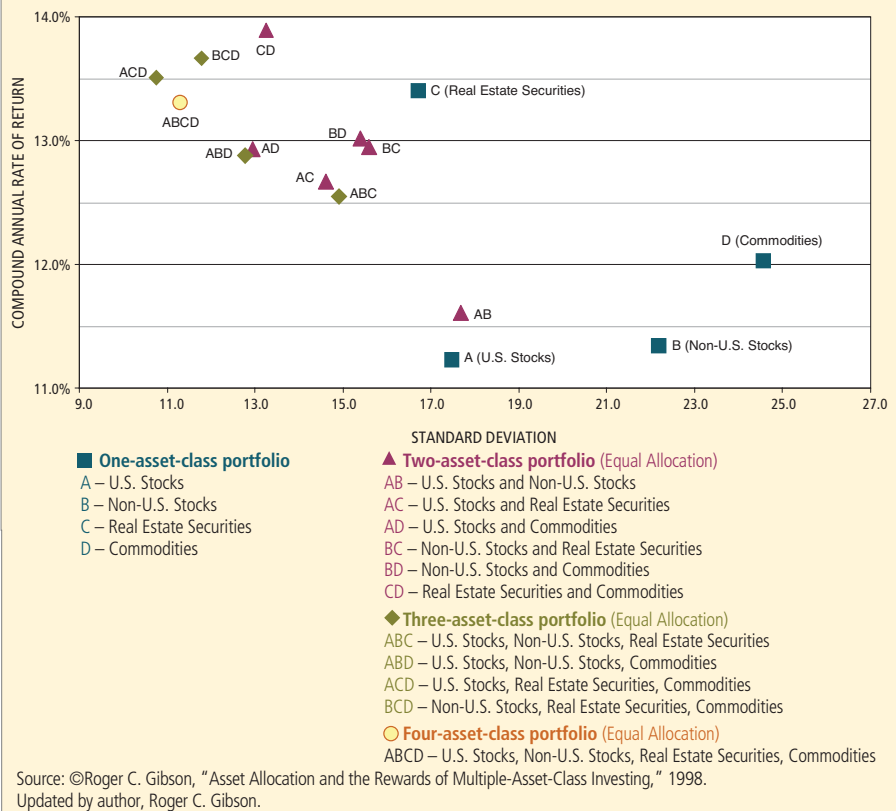
When an investor chooses a triangle portfolio over a square, he or she is indicating a preference for two-asset-class portfolios over single-asset-class portfolios. This decision is a rational one, since the two-asset-class portfolios, in general, have less volatility and more return than the single-asset-class portfolios. Likewise, the three-asset-class portfolios (diamonds) have better volatility/return characteristics than the two-asset-class portfolios (triangles), and the four-asset-class portfolio (circle) is a better choice than a random placement in one of the three-asset class portfolios (diamonds). The order of preference moves to the left in the direction of less volatility and upward toward higher returns.

The reduction in volatility observed as we progress from one- to four-asset-class portfolios is not unanticipated. We expect this due to the dissimilarity in returns among the portfolio components. The generally rising pattern of returns, however, is surprising. Portfolio D (Commodities), for example, had lower returns with considerably more volatility than Portfolio C (Real Estate Securities); yet a portfolio allocated equally between the two had a higher return with much less volatility than either of its components. Achieving a higher level of return for the mix than for either component depends on periodic portfolio rebalancing.

When comparing the returns of these 15 equity portfolios, we find that single-asset-class portfolios generated three out of the four lowest returns, whereas the highest returning portfolios were mostly multiple-asset-class structures. When we compare the volatility levels of these portfolios, we find that four out of the five most volatile portfolios were single-asset-class structures. The low volatility alternatives are all multiple-asset-class portfolios.

The best-performing portfolios occupy the upper left portion of the graph. These portfolios generated the highest returns with the least volatility. Multiple-asset-

**EXHIBIT 5: Fifteen Equity Portfolios, 1972 – 2005**



class portfolios dominate this space. The worst-performing portfolios are in the lower right portion of the graph. Four portfolios occupy this space. Three are single-asset-class portfolios (U.S. Stocks, Non-U.S. Stocks, and Commodities), and one is a two-asset-class portfolio (U.S. Stocks with Non-U.S. Stocks).

Return for a moment to the four single-asset classes. If we offer investors the opportunity to choose how they would invest their money, given complete certainty that each asset class would perform as indicated on Exhibit 5, they would likely pick Portfolio C — Real Estate Securities. The choice seems obvious. Real Estate Securities had both a higher return and less volatility than any of the other asset classes. Yet a portfolio allocated equally among all four asset classes (ABCD) had a return comparable with Real Estate Securities but with a third less volatility. Compare the position of C versus ABCD in Exhibit 5. This amazing result occurred despite the fact that each of the other three asset classes had lower returns with more volatility than Real Estate Securities.

If we asked a volatility-averse investor to eliminate one of the four asset classes as a building block for the multiple-

asset-class portfolios, he would probably choose Portfolio D — Commodities. Of all 15 portfolios in Exhibit 5, Portfolio D is the most volatile. Yet the six least volatile portfolios have Portfolio D as an equal component. Obviously there is more going on here than is captured by the return/volatility dimensions of Exhibit 5. We are missing the crucial information about how each asset class's pattern of returns correlates with the others'. The Commodities asset class, for example, has a pattern of returns that is the most dissimilar to the other asset classes. It accordingly produces the strongest diversification effect when combined with other asset classes.

Exhibit 6 shows the performance statistics for the 15 equity portfolios. The data in this table make a very strong case for multiple-asset-class investing. For investors concerned primarily with maximizing portfolio returns, we see that multiple-asset-class strategies have dominated single-asset-class strategies. For investors who are more concerned about minimizing volatility, again multiple-asset-class strategies are superior. The Sharpe Ratios displayed provide a risk-adjusted performance measurement for each portfolio.<sup>4</sup> Again, we find multiple-asset-class strategies delivering much higher rates of risk-adjusted returns than single-asset-class strategies.

At the bottom of Exhibit 6 we find summary comparisons for four-, three-, two- and one-asset-class approaches. This summary provides perhaps the most compelling argument for multiple-asset-class investing. As we move toward broader diversification, rates of return increase, volatility levels decrease, and Sharpe Ratios improve. The four-asset-class portfolio has a compound rate of

### EXHIBIT 6: Fifteen Equity Portfolios Performance Statistics, 1972 – 2005

COMPOUND ANNUAL RETURNS Future values of \$1.00 Ranked High to Low			STANDARD DEVIATIONS (Volatility) Ranked Low to High		SHARPE RATIO Ranked High to Low	
	%	\$				
CD	13.89	83.23	ACD	10.76	ACD	0.72
BCD	13.66	77.78	ABCD	11.30	BCD	0.67
ACD	13.50	74.16	BCD	11.79	ABCD	0.67
C	13.40	71.84	ABD	12.79	CD	0.63
ABCD	13.30	69.86	AD	12.95	AD	0.58
BD	13.02	64.19	CD	13.28	ABD	0.58
BC	12.95	62.79	AC	14.62	AC	0.51
AD	12.93	62.51	ABC	14.92	BD	0.51
ABD	12.87	61.40	BD	15.41	C	0.50
AC	12.67	57.75	BC	15.60	BC	0.50
ABC	12.55	55.72	C	16.72	ABC	0.49
D	12.03	47.56	A	17.48	AB	0.39
AB	11.61	41.85	AB	17.69	A	0.38
B	11.34	38.51	B	22.19	D	0.35
A	11.23	37.25	D	24.58	B	0.33
AVERAGE PERFORMANCE STATISTICS: FOUR-, THREE-, TWO-, & ONE-ASSET-CLASS PORTFOLIOS						
FOUR	13.30	69.86	FOUR	11.30	FOUR	0.67
THREE	13.15	67.26	THREE	12.56	THREE	0.61
TWO	12.85	62.05	TWO	14.92	TWO	0.52
ONE	12.00	48.79	ONE	20.24	ONE	0.39

Source: ©Roger C. Gibson, "Asset Allocation and the Rewards of Multiple-Asset-Class Investing," 1998. Updated by author, Roger C. Gibson. **Past performance is no guarantee of future results.**

### EXHIBIT 7: The Five Worst Years, 1972 – 2005

PORTFOLIO STRUCTURES									
A U.S. Stocks		B Non-U.S. Stocks		C Real Estate Securities		D Commodities		ABCD Equal Allocation	
Year	Return (%)	Year	Return (%)	Year	Return (%)	Year	Return (%)	Year	Return (%)
1974	-26.45	1990	-23.20	1974	-21.42	1998	-35.75	2001	-12.77
2002	-22.12	1974	-22.15	1998	-17.51	2001	-31.93	1974	-7.63
1973	-14.67	2001	-21.21	1973	-15.52	1981	-23.01	1981	-5.73
2001	-11.88	2002	-15.66	1990	-15.34	1975	-17.22	1990	-3.16
2000	-9.13	1973	-14.17	1999	-4.62	1997	-14.07	1998	-1.04

Source: ©Roger C. Gibson, "Asset Allocation and the Rewards of Multiple-Asset-Class Investing," 1998. Updated by author, Roger C. Gibson. **Past performance is no guarantee of future results.**

return 1.3% higher than the average compound returns of its components. That is, a \$1 investment in an annually rebalanced portfolio of all four components has a future value of \$69.86, compared with an average future value of \$48.79 for the four components standing alone. The four-asset-class portfolio has 44% less volatility than the average volatility levels of its components. And the Sharpe Ratio of the four-asset-class portfolio shows that it has generated over 70% as much risk-adjusted return as the average of its components.

Exhibit 7 gives another picture of the risk reduction achieved by the breadth of diversification. Here we list

<sup>4</sup>The Sharpe Ratio is a measure of reward relative to volatility. A portfolio's Sharpe Ratio can be calculated easily using a simple spreadsheet program. The portfolio's returns are listed in one column and those for Treasury bills are listed in the next column. The differences between the portfolio returns and Treasury bill returns are computed in the third column. The Sharpe Ratio is equal to the average of the differences in column 3, divided by the standard deviation of those differences. The Sharpe Ratio affirms the notion that a portfolio should generate some incremental reward for the assumption of volatility; otherwise, it would be better to simply own Treasury bills.

the five worst years, from 1972 through 2005, generated by each of the single-asset classes as compared with the four-asset-class portfolio. Non-U.S. Stocks share four of five of the worst years for U.S. Stocks. Much of the improvement in downside risk is therefore due to the greater dissimilarities in patterns of returns between Commodities and Real Estate Securities relative to either U.S. Stocks or Non-U.S. Stocks. These dissimilarities were particularly valuable during the last two severe bear markets: 1973 – 1974 and, more recently, 2000 – 2002.

We often cannot see the beneficial impact on return created by broader diversification because diversification examples mix fixed-income investments together with equity investments. In this situation, the large difference between the returns of fixed-income and equity investments obscures the increase in portfolio return attributable to the diversification effect. Because the longer-term rates of return of the four equity asset classes used in our analysis were fairly similar, we can see the positive impact diversification has on both dampening volatility and increasing return.

## Why Isn't Everyone Doing Multiple-Asset-Class Investing?

If multiple-asset-class investing is so wonderful, why isn't everyone doing it? There are three primary reasons. First, investors lack an awareness of the power of diversification. The typical investor understands that diversification may reduce volatility, but suspects that diversification simultaneously impairs returns. As we have demonstrated, diversification tends to improve returns, not diminish them. Investors need to be educated about this dual benefit.

Second, the question of market timing arises. Investors naturally want to believe that there must be some way to predict which asset class will come in first place. And some money managers suggest that they, in fact, can accurately make such market timing predictions. Let's assume that we have a market timer with whom we consult annually for his prediction of the following year's best-performing asset class among U.S. Stocks, Non-U.S. Stocks, Real Estate Securities, and Commodities. Had he successfully predicted the winning asset class over the past 15 years, from 1991 through 2005, an investor following his recommendations would have

earned a compound rate of return of 30.14%. If such market timing skill exists, we should find evidence of money managers earning these rates of return. When we check Morningstar's database (as of 12/31/05), we find that there is a universe of 1,463 mutual funds with at least 15 years of performance history. Included is the full variety of professionally managed, domestic and international funds, equity and fixed-income funds, as well as various specialty funds. How many of these funds had compound rates of return in excess of 30.14%? None. Not one got remotely close.

Perhaps we are asking too much of our market timer. What if we ask him to simply recognize the long periods of superior returns for an asset class compared to others? For example, our market timer might instruct us to invest our funds in U.S. Stocks during the portion of the 15-year period that fell in the 1990s when the U.S. market was generating eye-popping returns, and then switch to Real Estate Securities, which have done extraordinarily well during the 2000s. This strategy would have generated a compound return of 20.62%. Only one fund out of the universe of 1,463 funds had a higher return. This particular fund was a sector fund and, as such, did not rely on market timing as a strategy. Apparently, successfully predicting the relative performance of asset classes is difficult to do.

## Investor Psychology

The third reason involves investor psychology. Investors use their domestic market as a frame of reference for evaluating their investment results. For example, a U.S.-based investor will compare his equity returns with a market index such as the Standard & Poor's 500 Stock Index. This frame of reference is not a problem in years when the U.S. market underperforms other asset classes, because diversification into better-performing markets rewards a multiple-asset-class investor. When the U.S. market comes out on top, however, the investor perceives that diversification has impaired his returns. This sense of winning or losing arises primarily from the investor's immediate frame of reference. For example, the four-asset-class portfolio we have been discussing had a 14.16% return in 2005. U.S.-based investors perceive this as a "winning" return given the 4.91% return generated by U.S. Stocks in 2005. The same 14.16% return, however, pales in comparison to Commodities'

2005 return of 25.55%. Whether the 14.16% return from the four-asset-class portfolio looks good or bad depends on your frame of reference.<sup>5</sup>

An earlier version of this article was published in the March 1999 issue of the *Journal of Financial Planning* — exactly one year before the onset of the worst U.S. stock bear market in nearly three decades. At the time, everyone's favorite asset class was U.S. Stocks, driven by the superlative returns delivered to investors toward the end of the 1990s. Despite the fact that multiple-asset-class investment strategies were doing just fine, some investors abandoned broad diversification because "fine" returns were not good enough. They wanted spectacular returns and it seemed that in the "new economy" the place to get those returns was in U.S. large company growth stocks, or, better yet, technology and Internet stocks. When the 2000 – 2002 bear market hit, inadequately diversified investors were hit hard. The multiple-asset-class investor, however, was helped by the offsetting positive performance from other asset classes in his portfolio, particularly Real Estate Securities and Commodities.

We should not underestimate this "frame of reference" problem. Investors compare their investment results with their friends while playing golf or at cocktail parties. The true multiple-asset-class investor is still in the minority. During periods when the U.S. market prevails, he will feel particularly vulnerable talking with friends who own a more traditional domestic stock and bond portfolio. I once had a client tell me that he would rather follow an inferior strategy that wins when his friends are winning and loses when his friends are losing, than follow a superior long-term strategy that at times loses while his friends are winning. Sometimes it is painful being different.

Each year, the multiple-asset-class strategy loses relative to some of its component asset classes and wins relative to others. That is the nature of diversification. As a friend in the business observed, the problem with diversification is that it works whether or not you want it to!

Equity investing is a long-term endeavor. Investors should devise and implement strategies with the long term in mind. Investors naturally attach more significance to recent investment experience than to longer-term performance, but they should resist the temptation to abandon more diversified strategies in favor of chasing yesterday's winner.

The multiple-asset-class investing analysis presented here is a pedagogical illustration that, for simplicity, uses equally weighted strategies of various combinations of U.S. Stocks, Non-U.S. Stocks, Real Estate Securities, and Commodities. Although I am a strong proponent of multiple-asset-class investing, I do not recommend an equally weighted strategy for my clients. My reasoning is partially rooted in the psychological concerns of this "frame of reference" issue. From an investor psychology point of view, a more suitable alternative, for example, would be to weight a familiar asset class like U.S. Stocks more heavily in a portfolio than commodities — an unfamiliar asset class to many investors. This reduces the "frame of reference" risk.

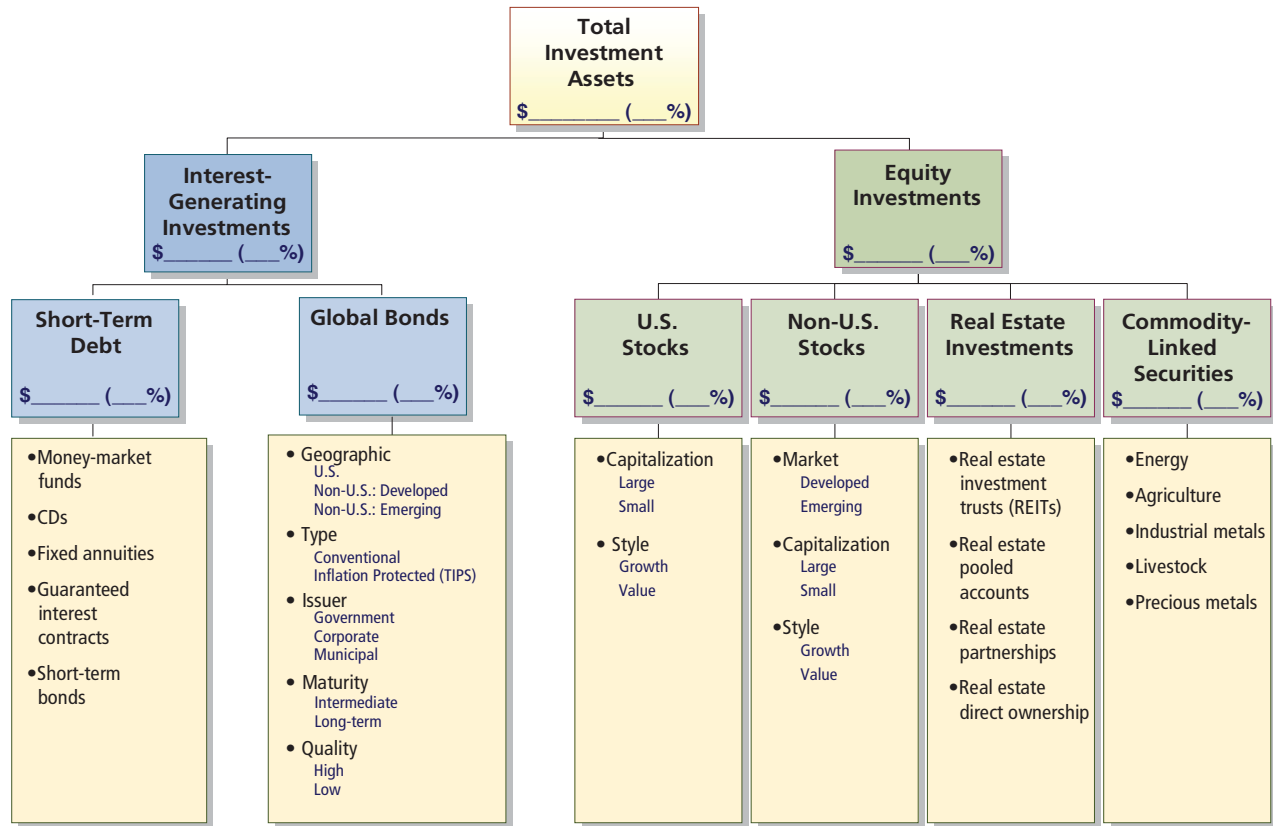
If it makes good investment sense for a client to have an allocation to a particular asset class, the first dollars into that asset class have the biggest impact on improving the portfolio's volatility-adjusted returns. When considering both the art and science of portfolio design, therefore, it is more important to have a *meaningful* allocation to an asset class that the client will remain committed to, than to have an *optimal* allocation if the latter raises the likelihood that the strategy may be abandoned.

Occasionally, a client follows this analysis and questions its merit because it relies on historical data that may be irrelevant when looking into the future. His or her argument rests on the notion that the world is very different today than it was during the time period covered by my multiple-asset-class investing analysis. Risks and opportunities exist now that have no historical precedent. Although that may be true, investor behavior is much the same as it has always been. Investors prefer predictability to uncertainty, and they face a menu of investment alternatives differentiated according to their levels of volatility. The buying and selling activity of investors establishes security prices that bring supply and demand into equilibrium. For this to occur, more volatile asset classes generally will have higher expected returns than less volatile asset classes. This leads to competitive, risk-adjusted returns across investment alternatives. The diversification benefits of a multiple-asset-class approach rest on the dissimilarity in patterns of returns across investment alternatives in the short run and competitive asset pricing in the long run. These conditions should hold in the future, even in the face of risks and opportunities that are unique to our times.

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<sup>5</sup> Performance numbers are for the 2005 one-year period.

## EXHIBIT 8: Investment Portfolio Design Format



Source: ©Roger C. Gibson, *Asset Allocation: Balancing Financial Risk*, Third Edition, McGraw-Hill Publishing, New York, NY, 2000. Updated by author, Roger C. Gibson.

But for the sake of argument, let's assume with the critics that the future is simply unknowable. If we have no basis upon which to make predictions about the future, the wisest investment strategy is to broadly diversify portfolios in order to mitigate the risks of unknowable markets. Their criticism, in fact, supports the argument in favor of multiple-asset-class investing.

### Investment Portfolio Design Format

Exhibit 8 provides a format for designing a portfolio according to the principles discussed in this article. We begin at the top with the total value of the investor's portfolio. Investors naturally tend to prefer to retain their current investment holdings. This inertia inhibits clear investment decision making. To overcome this problem, it is helpful if the investor hypothetically converts all of his current investments to cash before proceeding with

the portfolio design. This process creates an opportunity for the investor to make fresh decisions based on his present and future needs, unencumbered by the consequences of his past investment decisions.

The most general level of decision making is the balance between interest-generating investments and equity investments. This is the most important decision the investor makes, as it determines the portfolio's growth path through time and the general volatility level. Subject to this broad portfolio balance decision, the investor proceeds down to the asset allocation level. Here I advocate a globally diversified, multiple-asset-allocation approach. The interest-generating investments are subdivided into "short-term debt" and longer maturity "global bonds." The equity investments are allocated across four asset classes. The 15-equity portfolio analysis previously discussed uses an index representing each of

these equity asset classes. By globally diversifying the portfolio in this manner, the investor creates the opportunity for the diversification effect to work its magic. The final level of decision making involves the choice of specific investment positions to execute the strategy.

## Conclusion

Asset allocation is vitally important. The benefits of diversification can be powerful and robust, not just in terms of volatility reduction, but also for return enhancement. To evaluate the desirability of an asset class as a portfolio building block, it is not enough to know only its return and volatility characteristics. We must also know how its pattern of returns correlates to the patterns of returns of the other portfolio components. All other things being equal, the more dissimilarity there is among the asset classes within a portfolio, the stronger the diversification effect, providing investors with not only less volatility but also greater expected returns in the long run.

The beauty of diversification lies in the fact that its benefits are not dependent on the exercise of superior skill. They arise from the policy decision to follow a multiple-asset-class investment approach. Imagine for a moment that each of the portfolios in Exhibit 5 represented the performance of a different common stock manager, actively engaged in trying to outperform their competitors through superior skill in security selection. We would want to know what the managers

in the upper left portion of the graph are doing to generate returns that are, on average, over one percent higher with more than a one-third reduction in volatility, as compared with U.S. Stocks. Amazingly, these marked performance advantages did not rely on skill, but rather a simple policy decision: diversify!

The multiple-asset-class strategy is a tortoise-and-hare story. Over any one-year, three-year, or ten-year period, the race will probably be led by one of the component single-asset classes. The leader will, of course, attract the attention. The tortoise never runs as fast as many of the hares around it. But it does run faster on average than the majority of its competitors, a fact that becomes lost due to the attention-getting pace of different lead rabbits during various legs of the race. The 15-equity portfolio illustration we have discussed covers the time period 1972 through 2005. Think of it like a 34-year race with four contestants. The Commodities asset class had the highest compound return during the 1970s portion of this race. During the 1980s, Non-U.S. Stocks took the lead. In the 1990s, U.S. Stocks were in first place. So far in the 2000s, Real Estate Securities have outpaced the other three. There is always a hare running faster than the multiple-asset class tortoise, and, depending on the leg of the race, it is usually a different hare that takes the lead! Yet the tortoise, in the long run, leaves the pack behind. We know the moral of the story: slow and steady wins the race. In the end, patience and discipline are rewarded. To secure the reward, we need to relinquish our domestic frame of reference and invest as citizens of the world.

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**Roger C. Gibson, CFA, CFP<sup>®</sup>**, is perhaps best known as the author of *Asset Allocation: Balancing Financial Risk*, Third Edition (McGraw-Hill). Roger has been a frequent speaker at professional conferences on the topics of asset allocation and investor behavior for two decades. He is the Chief Investment Officer of Gibson Capital Management, Ltd., an investment advisory firm located in Pittsburgh, Pennsylvania, that serves high-net-worth clients and institutions nationwide.

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