

## Comfort, But No Joy

Observe any chocoholic, or addict of any kind, and you can see that what someone wants is not necessarily good for them. So-called comfort food has a tendency to add an uncomfortable girth to our waistlines. We know what investors want to buy – we observe it in the investments new clients bring in when they start their relationship with Sigma. The vast percentage of assets new clients transfer into Sigma accounts are either large company U.S. stocks or cash. It is comforting to own only well-known, blue chip names like General Electric, Microsoft or Johnson & Johnson. But is it good for you?

As a thought experiment, we decided to consider the past six calendar years, including three years of a bear market (2000-2002) and three years of a bull market (2003-2005). An investor in the Standard and Poor's 500 average of large U.S. stocks had a *negative* cumulative return of 6.51 percent over those six years.

However, what if we did not limit ourselves to buying large company stocks? What if we were able to diversify, and add different types of assets pursuant to Sigma's models? For the purposes of comparison, we used index performance data, assuming away the need for anyone to be an investing genius.

If we expand our universe to invest about three-quarters in large stocks and about a quarter in small stocks, it makes a dramatic difference – a positive cumulative return of over seven percent. If we add developed country foreign stocks, and continue to rebalance, we add another half percent. Finally, if we add a small dollop of emerging market stocks, we pick up another percent and a half of cumulative return.

Moving from only large company stocks to a diversified portfolio, we picked up a net cumulative return of 16 percent. Each of the assets we added to diversify our starting portfolio have higher volatility of returns than large U.S. stocks – in some cases, much higher. However, they move at different times and in different ways than large U.S. stocks. Adding these riskier assets to the portfolio does not necessarily make the overall portfolio riskier – the diversified portfolio did not lose as much in the bear market as the Standard and Poor’s 500. Investors also like to hold cash more than bonds, but intermediate term bonds had a cumulative return over the six years almost 25 percent more than holding a money fund.

**Many investors commit the fallacy of *reductio ad robotus*, incorrectly assuming they will be mechanical and unemotional.**

Most investment firms are not out to get you to look beyond large U.S. stocks because they are prone to focus on what is easiest to sell. If you are comfortable with large U.S. stocks, large U.S. stocks are what you they will sell you. In addition, like their prospects, investment firms do not want to

stretch beyond their comfort level. They would have to extend their minds to think about these other investments, do additional research, and then have to expend extra effort to make the sale to their customers anyway.

OK, let us say you want to achieve the wonders of diversification on a do-it-yourself basis. This commits the fallacy we call *reductio ad robotus* – blithely and incorrectly assuming you will behave in a mechanical, counter-intuitive manner, immune from emotion. We specified annual rebalancing in our thought experiment. “Rebalancing” is one of those nice terms that everyone talks about, but few actually do. It means taking money away from the assets in the portfolio that have done the best (the investments you love and feel good about) and giving the money to the assets in the portfolio that have done the worst (the investments you hate and wish you had never heard of). For example, at the end of 1998, large stocks had beat small stocks for five straight years. Would you really sell large stocks to rebalance into the lagging but relatively cheap small stocks? This was a seriously counter-intuitive act, but small stocks did better over the next six years. Doing what is comfortable in investing (for example, not rebalancing) can be very costly.

What percentage of your portfolio was in equities on March 31, 2000 and March 31, 2003, near the top and bottom of the bear market? Someone who rebalanced would have roughly the same percentage in stocks on the second date as on the first – but only a tiny minority of investors (a minority that includes Sigma’s clients on those dates) can make that claim. Asset allocation and rebalancing are not concepts that have been tried and found wanting; they have been found demanding and not tried.

What brings initial comfort (e.g. investing only in large U.S. stocks and cash) may not bring joy when it comes time to add up your investment returns. We can help you apply a rational approach and discipline to build a better portfolio, to make more comfortable what is rewarding. Call us at (503) 419-3938 or check us on the web at [www.sigmainvestment.com](http://www.sigmainvestment.com).