Wall Street's Real Winners

By Richard D. Romey

Wall Street loves a winner. Mutual fund managers who post spectacular returns are routinely paraded in front of the cameras like celebrities on the red carpet at the Oscars. They grace the covers of those glossy financial magazines wearing thousand dollar designer suites and smug smiles that project an air of superiority. Their words of market wisdom are treated as sacred. As lowly investors, we should be grateful to pay huge fees to have one of these superstars manage our mutual fund.

Unfortunately for investors, these winning fund managers' success is usually fleeting. Market trends change. When they do mutual fund managers that had produced spectacular returns usually come crashing down. The former stars are tossed out for the newest winners. The same magazines and newspapers that had heralded them as great fund managers tear them down and point out their failings, all the while building up the next batch of market winners.

What every mutual fund investor needs to understand is that the latest fund superstars are not the "real" winners when it comes to investing. The real winners are investors with diversified portfolios. Oh, I know that diversification is a boring topic. If you don't believe me just try talking about it the next time you're at a party and someone is telling the group about the spectacular returns they made with the latest hot mutual fund. Don't be afraid. Speak up and let everyone know that your portfolio is strategically diversified among various asset classes. Talk about a conversation killer.

Diversification may be boring but it wins again and again. Consider the following portfolio: 25% invested in large cap equities using the Russell 1000 Index, 15% invested in mid cap equities using the S&P Mid Cap 400 Index, 10% invested in small cap equities using the Russell 2000 Index, 10% invested in international equities using the MSCI EAFE Index and 40% invested in fixed income using the Lehman U.S. 7-10 Year U.S. Treasury Index. Each year on January 1st the portfolio is re-balanced to the exact same percentages.

Before we go any further it's important to point out that you can't actually invest in an index. However, there are many investment choices that allow you to closely track the performance of a given market index or benchmark. The two most widely used investment products are index mutual funds and exchange-traded funds (ETFs). While each product has fees that will slightly reduce the actual return you earn compared to the index return, the fees are typically very low.

How did the diversified portfolio do over the last 10 years? From 12/31/1996 to 12/31/2006, the portfolio had an average annualized return of 9.0% per year. In contrast, the overall market, as measured by the Dow Jones Total Market Index, returned 8.52% per year. Over the last 5 years the diversified portfolio had an average annualized return of 8.6% per year compared to only 7.0% for the market.

More impressively, during three of the worst years the market has experienced in the last four decades, the diversified portfolio did great. For example, in 2000 the Dow Jones Total Market Index, had a return of -9.2%. Over this same period the diversified portfolio gained 4.85%. In 2001 the market had a return of -11.9% while the diversified portfolio returned -2.4%. Finally, in 2002 the market had a return of -22.1% while the diversified portfolio only lost 5.4% or just a

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fraction of what the market lost.

The diversified portfolio protected the investor during serious market declines yet still produced a 10 year average annualized return of 9.0% per year. Diversification allows you to reduce risk while maximizing return. In my opinion, that's a winning portfolio.

Now that we know the formula for creating a winning portfolio, the question is how to best implement our diversified portfolio? The answer is simple: index-based investments. Indexing is a strategy designed to track the performance of various market indexes or benchmarks. Based on the fact that the majority of all actively managed mutual funds fail to beat their comparative benchmarks in any given year, indexing is a smart way to invest.

My favorite index-based investments are exchange-traded funds, which allow you to easily and efficiently implement a diversified investment portfolio. ETFs are essentially index mutual funds that trade throughout the day on an exchange. First created in 1993, ETFs are the fastest growing investment product in the history of Wall Street, based on assets under management.

ETFs are a good investment tool to use when building a diversified portfolio because they tend to have lower expenses than traditional mutual funds and are generally more tax efficient. There is a wide-range of ETFs available tracking hundreds of different equity and bond indexes. Finally, ETFs can be bought or sold throughout the day making it easy to build and manage your portfolio.

It's easier than you think to become a stock market winner. Best of all, it doesn't take connections at the top brokerage firm or membership in an exclusive Wall Street health club where stock tips are passed around in the sauna. All it takes is a little planning, discipline and the right investment tool to make sure that your portfolio is a real Wall Street winner.

About the Author

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1. The Diversification Benefits of Asset Allocation.
2. The Efficiency of Exchange-Traded Funds.
3. Continuous and Ongoing Portfolio Monitoring

To find out more about our approach to portfolio management, or to schedule a meeting, call us at 913-851-1100 or email to rich@etfportfoliopartners.com

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