Beekman Wealth Advisory

What You Know That Just Ain't So:
Conventional Wisdom on Building a Portfolio

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

-Mark Twain

Over the course of their investing lives, most owners of substantial pools of capital will hear a large number of misstatements, partial truths, and out-and-out whoppers about investing. These ideas are typically part of a well-rehearsed sales pitch, often by someone who has a financial interest in getting investors to believe them. They may sound very seductive. Some have been bandied about so widely that they've almost reached the status of folk wisdom.

At best, such misinformation can cause investors to spend time and energy chasing after the unattainable — high return with no risk, for example. At worst, investors can end up losing money, and sometimes lots of it.

This paper is part of an ongoing series[1] *by Beekman Wealth Advisory ("BWA") addressing common misconceptions about wealth management and investment practices. The goal of the series is to correct erroneous ideas, and to set forth the reality of what can and can't be achieved. Taking these flawed ideas with a large grain of salt will help investors steer clear of some potential dangers to their portfolios.*

Here's a preview of some dubious ideas that just ain't so about building a portfolio:

1. *There are sophisticated investments, not available to the general public, that provide everything you want in one package.*
2. *To reduce your risk, diversify more.*
3. *There are many asset classes, and to be properly diversified, you need them all.*
4. *Non-correlated assets will enable your portfolio as a whole to rise steadily.*

Dubious Idea #1: There are sophisticated investments, not available to the general public, that will provide everything you want in one package.

Investors want many things from their portfolios. Most investors would like to find high income, high total returns, minimal volatility, little or no risk of loss, low fees, daily liquidity, the ability to keep up with inflation, and no taxes.[2] And they'd like it all in one package. And there are — regrettably — investment salespeople who try to sell such investments to credulous investors. Pitching these and other investments as special and not widely available is a common technique for making them seem more attractive.

Unfortunately, this investment does not exist. It never will. But investors may want to believe that they have found such an all-in-one investment, to their later regret.

Generally speaking, it is possible to find investments offering two, three or even four of these characteristics — but at the cost of giving up other desirable investment qualities.

For example:

- Equity-oriented index funds may[3] offer the potential for attractive returns over time, along with low fees and daily liquidity. However, they also carry meaningful risk of loss, normal stock-market volatility, and taxes on income and capital gains.

[1] Additional presentations in this series may be accessed at www.beekmanwealth.com, or via request to info@beekmanwealth.com.

[2] Future market returns are inherently unknowable. Nothing in this paper should be construed to provide any prediction or guarantee of future returns or outcomes.

[3] Potential returns depend critically on the going-in valuations. Normally, the cheaper the going-in valuations, the higher the potential long-term returns.

- There are packages of investments, called structured products, marketed as offering both the possibility of participating in stock market gains and downside protection — but they almost always come with hidden risks and high fees.

- Money market funds usually carry little or no risk of principal loss, very stable principal values, daily liquidity, and very low fees — but the returns are very low, and often don't keep up with inflation.

And so on. Wise investors know that anything that sounds too good to be true, is. If there appears to be no downside to an investment…you just haven't looked hard or deep enough.

BWA Truth #1: Investing *always* entails trade-offs.

Dubious Idea #2: To reduce your risk, diversify more.

"Diversify!" is an imperative every long-time investor has heard and read hundreds of times. If it's risky to "put all your eggs in one basket", then the answer must be to have a lot of baskets. (Along with a lot of eggs.)

And — to a point — diversification is useful. Anyone who had much of their money invested in the stock of Lehman Brothers, or under the management of Bernie Madoff, would have been better off with a more diverse set of securities and managers, for sure.

But more is not always better. It is quite possible to reach a point of diminishing returns to diversity…and then to continue on to the point where added complexity has a *negative* impact on portfolio management. Peter Lynch, the manager of Fidelity Magellan in its stellar early years, called this "de-worse-ification".

Consider this real-life example:

Some years ago, an investor came to Beekman Wealth Advisory asking for a second opinion on her portfolio. The assets totaled about $4 million. The portfolio included, among other holdings:

- 33 mutual funds investing in U.S. equities, including 3 separate S&P 500 index funds;
- 8 mutual funds investing in non-U.S. equities;
- 7 mutual funds investing in municipal bonds; and
- 11 mutual funds investing in taxable bonds.

Unsurprisingly, most of the mutual funds were those sold by the company employing this investor's financial advisor. A lot of them invested in very similar baskets of securities. Of the 33 U.S. equity mutual funds, 25 focused on large-cap stocks, many of them held in common.

This investor's extreme diversification did not shield her portfolio from major losses, like those incurred in the fourth quarter of 2008. What it did do was to (1) make it nearly impossible for her to understand what, exactly, she had; (2) raise her tax and accounting bills; and (3) cause her to forfeit the benefit of fee breakpoints[4] she would have received by making fewer, but larger, investments.

Wise investors add to their portfolios only those new investments that bring something truly unique and valuable (for example, an outstanding manager or an unduly cheap asset class)—*and then they stop adding.*

BWA Truth #2: Diversification is not a panacea. Excessive diversification becomes counterproductive.

Dubious Idea #3: There are many asset classes, and to be properly diversified, you need them all.

This is an idea that is often put forth by sellers of specialized or niche "asset classes". If you want to market, say, a Japan-only equity fund[5], it helps to convince investors that Japanese equities are a separate asset class, to which every properly-diversified investor should allocate money.

In fact, asset classes are broad categories of assets that derive their returns in similar ways, and that can be expected to respond in similar and predictable ways to economic stimuli. There are five basic asset classes:

1. **Stocks** (aka Equities) represent ownership of a proportionate share of a business. Stocks de-

[4]Fee breakpoints are reductions in fees, typically in loads, accruing as the amount invested in a single investment grows. For example, a fund might charge a front-end load (sales fee) of 4.75% to someone investing $5,000, but only 2% to someone investing $50,000.

[5]Or, for that matter, baseball cards or fine wine.

rive their returns from dividends, if any, and capital gains or losses (the difference between the price paid for purchase and the price received on sale).

2. **Bonds** (aka Fixed Income) represent loans made to borrowers. Bonds derive their returns from interest earned and capital gains or losses, if any. Unlike stocks, bonds have a fixed maturity date, at which time principal is paid back at par.

3. **Real estate** represents ownership in tangible property including land and buildings. Real estate derives its returns from rents received and capital gains or losses, if any.

4. **Commodities** represent fungible [interchangeable] goods, such as gold bars, barrels of oil, or vats of orange juice. Commodities typically do not generate cash during their holding periods. Instead, holding such goods requires cash *outlays,* for shipping, storage, insurance, and so on. Returns are derived from capital gains or losses, less the costs of holding. Currencies (the U.S. dollar, the euro, etc.) are a special case of commodities.

5. **Cash** is a store of value and medium of exchange. It derives its return, if any, from interest.

These five asset classes have existed since antiquity. Those who proclaim "new" asset classes today are almost always[6] describing what are, in reality, either sub-categories of these basic asset classes; new ways of accessing these basic asset classes; or new ways of packaging these basic asset classes.

For example, stock call options are contracts that provide a leveraged (meaning, essentially, that one pays the equivalent of a down payment to buy the contract) way of owning the profits from a stock price increase. They are an alternative format for capturing stock price appreciation, versus owning stock outright.

By the same token, municipal bonds and taxable bonds represent borrowings by different kinds of borrowers (states, cities, and other municipal borrowers, on the one hand; corporations and other taxable borrowers on the other). But they both still derive their returns from interest and capital gains and losses, if any. They are subcategories of the fixed income asset class.

"New and improved" are ubiquitous marketing words — because they work. But whether the product in question is detergent or pain reliever or the latest hot financial offering, consumers would be wise to probe the claim.

BWA Truth #3: "New" asset classes are usually existing asset classes, typically repackaged with a different marketing spin.

Dubious Idea #4: You can find non-correlated assets that will zig when markets zag, so your portfolio as a whole will rise steadily.

"Non-correlated" assets are one of the Holy Grails of investing. High return with no risk is another. These two are almost equally hard to find in real life.

Correlation is a statistic that describes the way two variables — such as the returns to two different investments — move together. Correlations range from +1.00 (or +100%) to -1.00 (or -100%). Two variables that have a +1.00 correlation move in exactly the same way — when one goes up +10%, for example, so does the other. Two variables that have a -1.00 correlation move in exactly opposite ways — when one goes up +10%, the other goes *down* -10%.

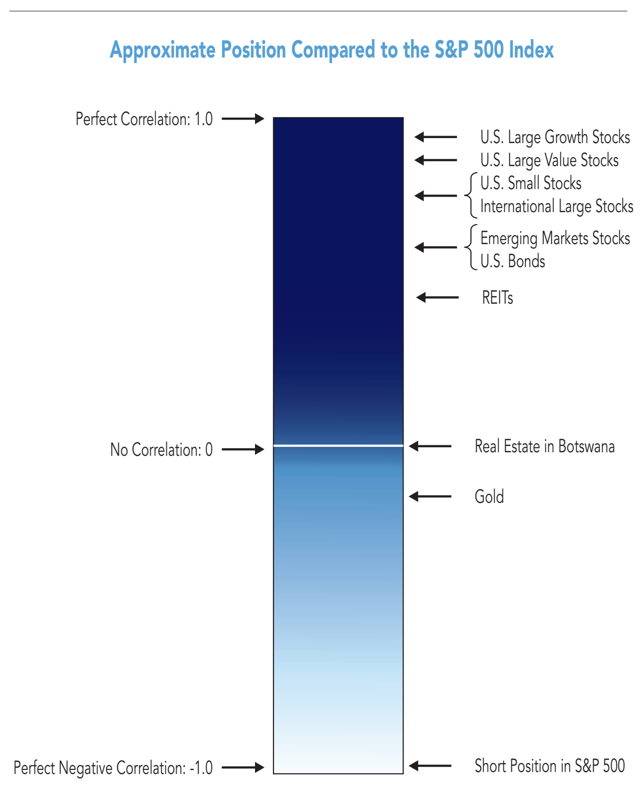
Two variables that have a 0.00 correlation—that is, that are non-correlated — have nothing to do with each other. Knowing that one went up +10% tells you nothing about what happened to the other, because they move completely independently of each other.

Non-correlated assets are a Holy Grail because an investor in assets that each had strong returns, but earned their returns in different ways at different times, could theoretically put together a portfolio that would smooth out the return pattern and mitigate losses. This is because, when one asset was going down, something else in the portfolio would be doing well.

[6]There *are* some investments that don't fit into this categorization. For example, life settlements represent the purchase of life insurance policies as an investment, in which premiums are paid to buy insurance on the life of, typically, a stranger, and the return is made when the insured dies and the investor collects the death benefit. This represents ownership of a legal claim, but not, arguably, an asset class.

Nice in theory, but very hard to do in reality, because broad economic factors tend to have broad effects. A surge in energy prices, for example, would tend to hurt stocks around the globe — not just in, say, the U.S. — by raising the price of a major input into the cost of production, and by redirecting consumer expenditures toward energy and away from other goods.

For this reason, most asset classes have positive correlations, some quite high. Below, for example, is a graphical representation of the approximate correlations of some major asset classes.[7]



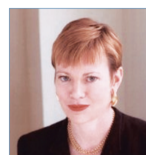
Why should this matter to investors? Because "non-correlated" is another term that is bandied about for purposes of marketing investments, even though it is nearly always inaccurate. A more accurate description would be "less-than-perfectly correlated" assets. And even then, investors have learned through hard experience that correlations rise at the worst possible times. In a market crash, such as the fourth quarter of 2008, almost everything goes down together.

BWA Truth #4: Truly non-correlated assets are very, very scarce.

Summary

In much of life, simplicity and clarity are deemed virtues. But in the investment world, all too often, *complexity sells.* That's why so many investors wind up with unwieldy portfolios full of too many investments, too much overlap, hidden risks, and disappointing results.

Our industry experience has taught us not to rely on "conventional wisdom" when it comes to investing. Building a portfolio that's "just right" can be a tricky proposition. There are trade-offs and risks that need to be evaluated carefully. A portfolio strategy that works well for one person could lead to a poor outcome for someone else, since everyone has different needs and circumstances. BWA applies a mix of careful assessment, understanding and practical knowledge in working with each client to determine an appropriate portfolio, tailored to that client's specific situation.



Elizabeth P. Anderson, CFA, is the founder of Beekman Wealth Advisory LLC, a boutique financial consultancy providing highly customized services to families and individuals. Founded in 2003, Beekman Wealth Advisory's business model reflects its unwavering commitment to the best interests of its clients.

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[7] The zero correlation shown between the S&P 500 and real estate in Botswana is an invented number; the writer is not aware of any actual index of real estate values in Botswana. But this is an example of a pair of assets with price movements that are likely to have little relationship with each other.