

## Following the Fundamentals

*By Ken Robinson*

During the market down-cycle in 2000 through 2002, many people who were riding high on large concentrated technology stock positions in the 1990's lost their entire original investment and their wealth shrank by 50% or more. Such disastrous results could have been avoided had these investors or their advisors not ignored the fundamental principles of investing.

### Properly Engineered Diversification

The recklessness of putting all of one's eggs in one basket is a self-evident truth—yet people continue to ignore the truth. Unforeseen events such as accounting scandals, new product successes and failures, bankruptcies, terrorist attacks, business cycles, criminal behavior, interest rate changes, etc. are a part of life. The timing and subsequent impact of such surprises on stock and bond prices is unpredictable. Even so, a certain percent of investors will inevitably over-concentrate their investments once again in hopes of “getting rich quick.”

The value of having a diversified portfolio including small cap, international, and value stocks, over a traditional domestic large growth portfolio has been well proven during the past few years. As the *S&P 500 Index* began to soar in the mid 1990's, many investors ignored the principles of diversification by concentrating most of their portfolio in this single asset class. Below are the annualized returns for the *S&P 500 Index* versus the diversified TMG 100% Equity model portfolio since the year 2000:

Year	Diversified 100% Equity	S&P 500	Difference
2000	0.69%	-9.10%	+ 9.79%
2001	0.88%	-11.88%	+ 12.76%
2002	-18.34%	-22.11%	+ 3.77%
2003	43.03%	28.67%	+14.36%

### A Focus on Risk

There is a relationship in finance and investing known as the risk-return trade-off. It can be summarized in the following way - in order to achieve higher rates of return, one must endure higher levels of risk and volatility. For example, investing in risk-free government bonds or low-risk FDIC insured CD's represents a minimal risk for which the investor receives only minimal returns. In order to maintain or improve one's standard of living over the long run, investors must outpace the inflation that continually eats away at the purchasing power of their dollars. Minimal returns will not accomplish this objective in the long term. Equities provide the higher rates of return needed to accomplish your long-term investment goals. The trade-off for these higher rates of return is higher levels of risk and volatility. The higher volatility of equities, also known as market risk, is unavoidable. Through asset allocation and diversification across thousands of stocks, however, we can achieve those higher rates of returns while virtually

eliminating business risk, which represents the danger of losing your entire investment in an individual company stock. (April 03)

### **Discipline**

In order to execute a successful investment plan, it is essential to stay focused on long-term objectives and avoid “bailing out” during these inevitable downturns. Remaining fully invested throughout these cycles allows investors to avoid the pitfalls of panic selling and bad market timing. Emotional selling results in *selling low* while the markets are down. In a similar fashion, many amateur investors attempt to time the market, only to end up *buying high* after missing a significant portion of a market recovery. Market turnarounds occur rapidly and no one can anticipate their exact timing or magnitude. A real turnaround cannot be identified until *well after the start* of a new bull market. (January 03)

Developing a carefully designed investment plan with multiple non-correlated asset classes was not popular when faced with the exploding technology sector during the 1990's. Yet, as the market imploded during the first three years of the new millennium, it is clear the time-tested, but unexciting, principles applied in your investment plan have proved their value. Avoiding emotional reactions while remaining properly diversified and fully invested throughout market cycles is the key to long-term success. That's the only “expert” way in today's fast-paced economy to build *and maintain* wealth.