
October 2012 Volume 2

**"Good morning, Eeyore," said Pooh.**

**"Good morning, Pooh Bear," said Eeyore gloomily. "If it is a good morning, which I doubt," said he.**

**"Why, what's the matter?"**

**"Nothing, Pooh Bear, nothing. We can't all, and some of us don't. That's all there is to it."**

**"Can't all what?" said Pooh, rubbing his nose.**

**"Gaiety. Song-and-dance. Here we go round the mulberry bush."**

**— A.A. Milne**

# Diversity

It's the differences that make us stronger. Where we are alike we can agree, but where we are different we can learn. This idea has great merit in many areas of our life. It has been one of the strengths of our society and a building block for companies great and small. Now, it would be easy to launch into a Kum-Ba-Yah diatribe fit for this political season, but that is not the subject that I care to write about today. Rather, I want to talk about the diversity of a portfolio … maybe your portfolio. Most investors are familiar with the idea of diversification. The act of ***not*** "putting all your eggs in one basket". Where did the idea come from, though? What does it really mean?

The idea has been around for a long time, but really became formalized for the investment community during the 1950's when Harry Markowitz published a series of papers and books dealing with diversification and risk, and which laid the foundation for most portfolio construction techniques over the last 50 years. Critics of Markowitz's theories have been more vocal in recent years as the financial crisis has called into question some of the basic tenets of the more advanced ideas and assumptions used in its creation. However, the basic idea of diversifying your holdings to reduce risk is still widely accepted. But what really is diversification and why does it work?

Consider an investor who owns shares in both AT&T and Verizon. Let's assume for simplicity's sake that she has diversified her holdings between these two companies. She has certainly reduced the risk of loss if either one of them were to go bankrupt. However, in the more likely scenario that there is a slowdown in the business climate for telecommunication services, she has likely done nothing to control her risk by owning both companies' stock. Why? The simple answer is ***correlation***. Intuitively, this makes sense. Because they are both in the same industry, they will likely both be responsive to business conditions that affect that industry. Correlation is the idea that a variable (in this case AT&T or Verizon) is dependent on a second variable (telecommunications services demand). We can also measure the correlation between both AT&T and Verizon. As you may have guessed, the correlation is high. Correlations are measured as a decimal between –1 and 1(at –1 they are perfectly negatively correlated and at 1 they are perfectly positively correlated). In this case they are 0.90+.

True diversification comes from owning not just a broad array of assets, but from owning those assets with *low* or *no* correlations. Correlations, then, are the secret sauce in creating a truly diverse portfolio. If the assets in your portfolio are many and seemingly different, this does not guarantee true diversity from risk. If the correlations are moderately high to high the portfolio may be just a diverse mix of highly correlated risky assets that will perform poorly when it's expected to be robust to market conditions. The investor then maintains a false sense of security by way of the "diversity" he holds in his portfolio.

| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Calamos Convertible A Load Waived | | | | | | | | | | | | | | | |
| 2 | Davis NY Venture A Load Waived | 0.93 | | | | | | | | | | | | | | |
| 3 | Delaware High-Yield Opportunities A ... | 0.77 | 0.82 | | | | | | | | | | | | | |
| 4 | Fidelity Real Estate Investment | 0.79 | 0.85 | 0.77 | | | | | | | | | | | | |
| 5 | Franklin Gold and Precious Metals A ... | 0.67 | 0.55 | 0.36 | 0.45 | | | | | | | | | | | |
| 6 | Henderson Intl Opportunities A LW | 0.93 | 0.92 | 0.83 | 0.75 | 0.54 | | | | | | | | | | |
| 7 | Ivy Small Cap Value A Load Waived | 0.88 | 0.94 | 0.80 | 0.82 | 0.49 | 0.84 | | | | | | | | | |
| 8 | PIMCO Commodity Real Ret Strat D | 0.80 | 0.76 | 0.67 | 0.62 | 0.67 | 0.77 | 0.66 | | | | | | | | |
| 9 | PIMCO Short-Term D | 0.51 | 0.50 | 0.72 | 0.41 | 0.27 | 0.57 | 0.47 | 0.47 | | | | | | | |
| 10 | PIMCO Total Return Instl | 0.26 | 0.25 | 0.55 | 0.37 | 0.31 | 0.33 | 0.17 | 0.41 | 0.73 | | | | | | |
| 11 | Royce Premier Invmt | 0.92 | 0.94 | 0.74 | 0.80 | 0.60 | 0.86 | 0.95 | 0.69 | 0.41 | 0.14 | | | | | |
| 12 | Rydex Inverse S&P 500 Strategy Inv | -0.92 | -0.98 | -0.78 | -0.85 | -0.52 | -0.91 | -0.93 | -0.74 | -0.45 | -0.21 | -0.92 | | | | |
| 13 | Templeton Developing Markets Adv | 0.88 | 0.89 | 0.83 | 0.72 | 0.64 | 0.91 | 0.81 | 0.82 | 0.55 | 0.37 | 0.84 | -0.86 | | | |
| 14 | Templeton Global Bond Adv | 0.83 | 0.80 | 0.80 | 0.72 | 0.62 | 0.85 | 0.73 | 0.81 | 0.62 | 0.52 | 0.76 | -0.77 | 0.89 | | |
| 15 | | | | | | | | | | | | | | | | |

Time Period: 10/1/2009 to 9/30/2012 — 1.00 to 0.80 · 0.80 to 0.60 · 0.60 to 0.40 · 0.40 to 0.20 · 0.20 to 0.00 · 0.00 to -0.20 · -0.20 to -0.40 · -0.40 to -0.60 · -0.60 to -0.80 · -0.80 to -1.00

Source: Morningstar Advisor Workstation

The chart above is a correlation matrix that shows the correlations of various assets in a typical portfolio. For example, if we look at line 11, Royce Premier Investment Fund, and scan over to column 4 we see 0.80. This tells us that Royce is 80% correlated to Fidelity Real Estate Investment Fund (#4 in our holdings). The real important take away from this graph, however, we can see visually. Those assets that are moderately to highly correlated show up in blue to dark blue shades.

Those assets that have a low correlation are either light blue or some shade of orange. As you can see, this “diverse portfolio” has a overall high degree of correlation. This has not always been the case. The first graph is a matrix that covers the last 3 years. In that time frame, the amount of monetary intervention in the markets by the Federal Reserve and other central banks has been unprecedented. It essentially has caused almost ***all*** assets to rise to one degree or another. This manipulation has caused the high correlation we observe in the asset markets today. In looking back at the graph you may notice there are only a very few assets that remain uncorrelated or have a low correlation. The Rydex Inverse Fund is a fund that shorts stock (bets that stock will go down). It would be expected to have a negative correlation to most assets and it does. The other item is Pimco Total Return Bond which has some hedge fund like characteristics and high turnover that has adeptly allowed it to perform well in different market conditions. There is only one other asset that has not been mentioned here that has a low correlation to most all assets and that is ***CASH.***

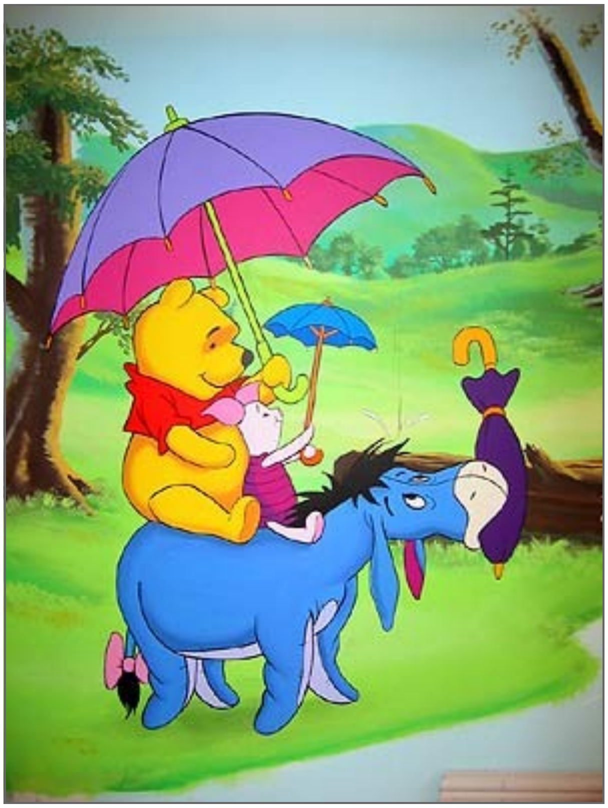
Now look at the following graph from the period January 2000 to January 2005. You will notice significantly lower correlation numbers as presented very vividly here with light blue, white and orange colors more representative of a truly diversified portfolio (these are all the same funds as our

| | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Calamos Convertible A Load Waived | | | | | | | | | | | | | | | |
| 2 | Davis NY Venture A Load Waived | 0.74 | | | | | | | | | | | | | | |
| 3 | Delaware High-Yield Opportunities A ... | 0.53 | 0.50 | | | | | | | | | | | | | |
| 4 | Fidelity Real Estate Investment | 0.34 | 0.33 | 0.21 | | | | | | | | | | | | |
| 5 | Franklin Gold and Precious Metals A ... | 0.36 | 0.28 | 0.19 | 0.38 | | | | | | | | | | | |
| 6 | Ivy Small Cap Value A Load Waived | 0.77 | 0.76 | 0.50 | 0.42 | 0.41 | | | | | | | | | | |
| 7 | PIMCO Short-Term D | 0.16 | 0.06 | 0.13 | 0.09 | 0.16 | 0.12 | | | | | | | | | |
| 8 | PIMCO Total Return Instl | -0.01 | -0.16 | 0.11 | 0.01 | 0.13 | -0.22 | 0.57 | | | | | | | | |
| 9 | Royce Premier Invmt | 0.73 | 0.80 | 0.52 | 0.44 | 0.35 | 0.88 | 0.04 | -0.27 | | | | | | | |
| 10 | Rydex Inverse S&P 500 Strategy Inv | -0.69 | -0.92 | -0.48 | -0.29 | -0.23 | -0.73 | 0.05 | 0.20 | -0.76 | | | | | | |
| 11 | Templeton Developing Markets Adv | 0.69 | 0.72 | 0.67 | 0.37 | 0.45 | 0.71 | -0.07 | -0.04 | 0.68 | -0.74 | | | | | |
| 12 | Templeton Global Bond Adv | 0.32 | 0.19 | 0.37 | 0.34 | 0.38 | 0.14 | 0.22 | 0.57 | 0.13 | -0.14 | 0.41 | | | | |
| 13 | | | | | | | | | | | | | | | | |
| 14 | | | | | | | | | | | | | | | | |
| 15 | | | | | | | | | | | | | | | | |

Time Period: 1/1/2000 to 1/31/2005 — 1.00 to 0.80 | 0.80 to 0.60 | 0.60 to 0.40 | 0.40 to 0.20 | 0.20 to 0.00 | 0.00 to -0.20 | -0.20 to -0.40 | -0.40 to -0.60 | -0.60 to -0.80 | -0.80 to -1.00

Source: Morningstar Advisor Workstation

previous graph with the exception of Henderson and Pimco Commodity as they were not available in the period). Remembering back to our earlier premise, to be properly diversified we would like as many uncorrelated assets to be represented in the portfolio as possible. The current monetary interventions have rendered this ideal close to impossible.  With a tightly correlated portfolio, everything that goes up together will likely go down together as well.  It is why, with the very few options we have to properly diversify these risks, we have recommended a higher cash position than we would normally find customary.  That can seem erroneous at times of market advance, however, it is an important component to make portfolios more robust against market declines.  We are not in normal times!



As always, we here at Clearview Investment Partners, LLC continue to strive to provide relevant information and advice to help you reach your individual goals. We hope you've had a great summer and travel season and would love to hear stories of your adventures!

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