

Vince Lombardi and The Seven Investment Fundamentals (Part I)

Famed football coach Vince Lombardi was so disappointed in his team's performance one season that he decided he needed to "go back to the basics." On the first day of practice the next season he walked into the locker room where the team was gathered, slowly walked to the front of the room, held up a football and said, "Gentlemen, this is a football."

Beginning in 1999, our firm authored a series of articles titled "The Seven Investment Fundamentals." We thought it would be a good idea to "go back to the basics" by revisiting these seven fundamentals to see what, if anything, we would change in light of recent market events.

To set the stage, here's all seven in capsule summary:

1. Have an Appropriate Allocation to Equities

Your allocation to equities (stocks) is the single strongest determinant of returns over long periods of time.

2. Stay Fully Invested

Market timing adds uncertainty, reduces efficiency and increases taxes and costs, all of which threaten your financial objectives.

3. Keep Costs Down

Lower costs improve long-term results geometrically. We believe the total annual portfolio costs should be no more than one percent.

4. Use Only Short-Term Bonds

Short-term bonds offer less risk than intermediate-term or long-term bonds. The risk exposure from long-term bonds is disproportionate to the small increase in return.

5. Include Small Cap Stocks

On average, small cap stocks produce higher returns than large cap stocks over time.

6. Include Value Stocks

On average, value stocks produce higher returns than growth stocks over time.

7. Have Broad Diversification

No single investment strategy works all the time. Increase returns and reduce risk through broad diversification applied consistently over long periods of time.

Our review of these fundamentals will be divided into three parts. Part I of this new series will cover fundamentals 7, 6 and 5. Part II will cover 4, 3 and 2 and Part III will conclude with the most important fundamental of all: Have an Appropriate Allocation to Equities.

Our fundamental number 7 is an appropriate place to start because many people have said that diversification failed in the recent bear market that started in October 2007 and ended in early March 2009. In previous bear markets, some asset classes of stocks held up better than others, making broadly diversified portfolios less volatile, thus helping our clients stay committed to their investment program.

The first concept of diversification is to put together investments that all do their part in producing the desired result – to generate a certain rate of return in the long run – but do so at different times. In other words, when one asset class is zigging, another one is zagging.

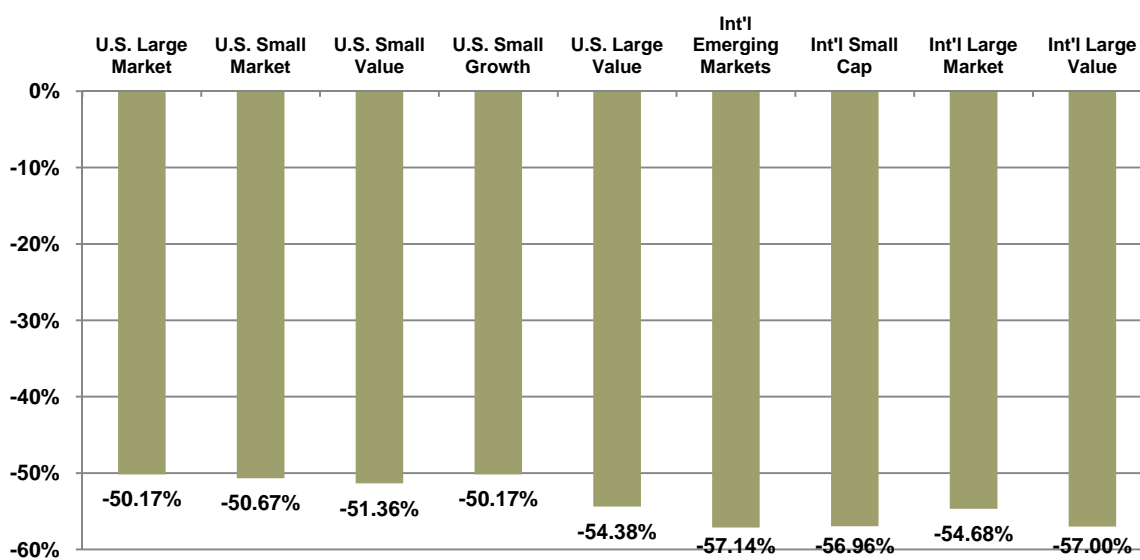
Let’s give an example in the context of Jane, who owns two businesses at the beach. One business sells sunglasses and the other sells umbrellas. When the sun is shining, her sunglass business does well but her umbrella business is terrible. When the rain comes, the opposite is true. Jane is smart enough to tell her accountant to give her a consolidated financial statement for the two businesses so when she looks at the results, the swings in one business are offset by the other, making the two businesses together less risky than owning just one.

The academics would say that Jane’s two businesses are “negatively correlated” or “uncorrelated”, i.e., they move in opposite directions. When investments are highly correlated, they move in the same direction. The science of portfolio construction is to combine asset classes in such a way to obtain the greatest amount of return for a desired amount of risk or the lowest amount of risk for a desired expected return. Using asset classes that have low correlation reduces risk.

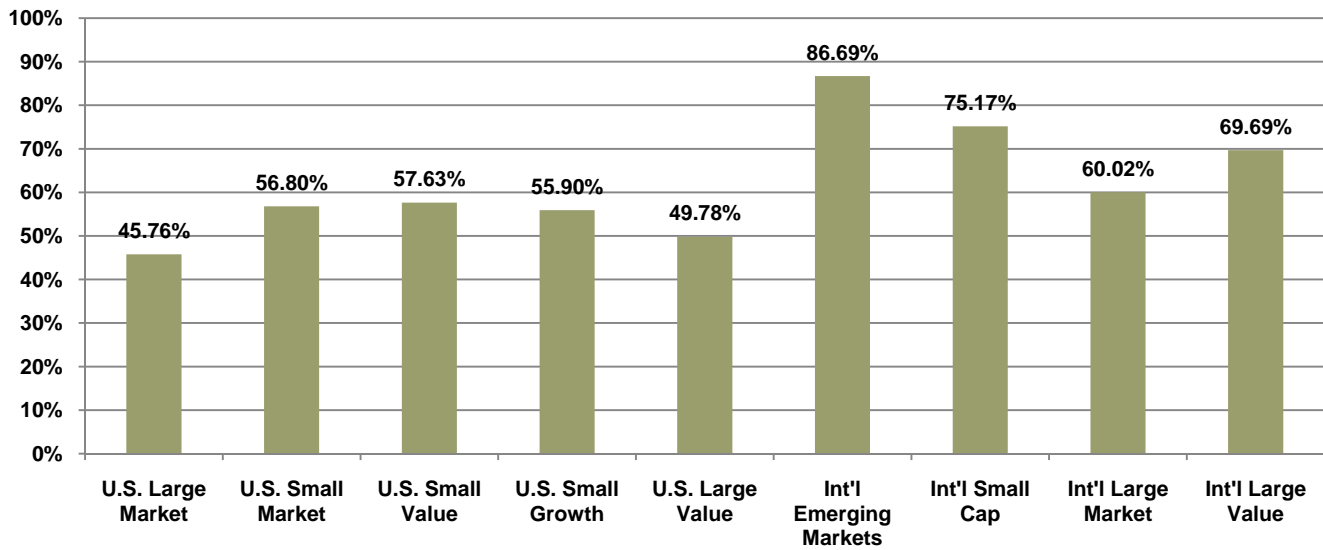
That leads us to the second concept of diversification – the elimination of cross-sectional risk. Cross-sectional risk is the risk of owning GM instead of Ford. If you own just a handful of stocks in several different sectors of the economy, you run the risk of picking the ones that do worse instead of the ones that do better. By owning virtually all stocks in a particular asset class, you eliminate cross-sectional risk. Clearly, this worked in the latest bear market and was probably more important than ever, in light of the failures of numerous once-revered companies over the past two years. Owning a passive “market” portfolio was clearly much safer.

So back to the zigging and zagging of multiple asset classes with low correlation – the reality is that the latest bear market was global and impacted virtually every asset class in the world. As many have said, there was “no place to hide” when it came to being an investor in equities **from late 2007 to early 2009**.

The table below sets forth the performance (total return; not annualized) of various asset classes from October 1, 2007 through February 28, 2009 (Latest Bear Market):



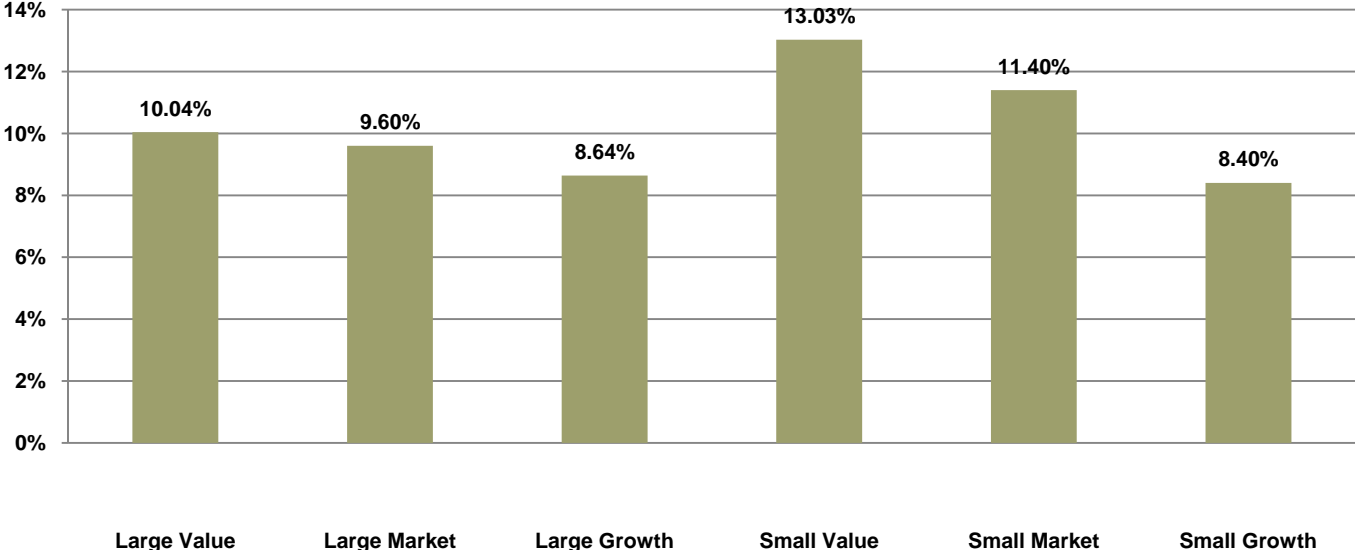
Now let's look at the performance (total return; not annualized) of the same asset classes from March 1, 2009 through September 30, 2009 (Latest Bull Market):



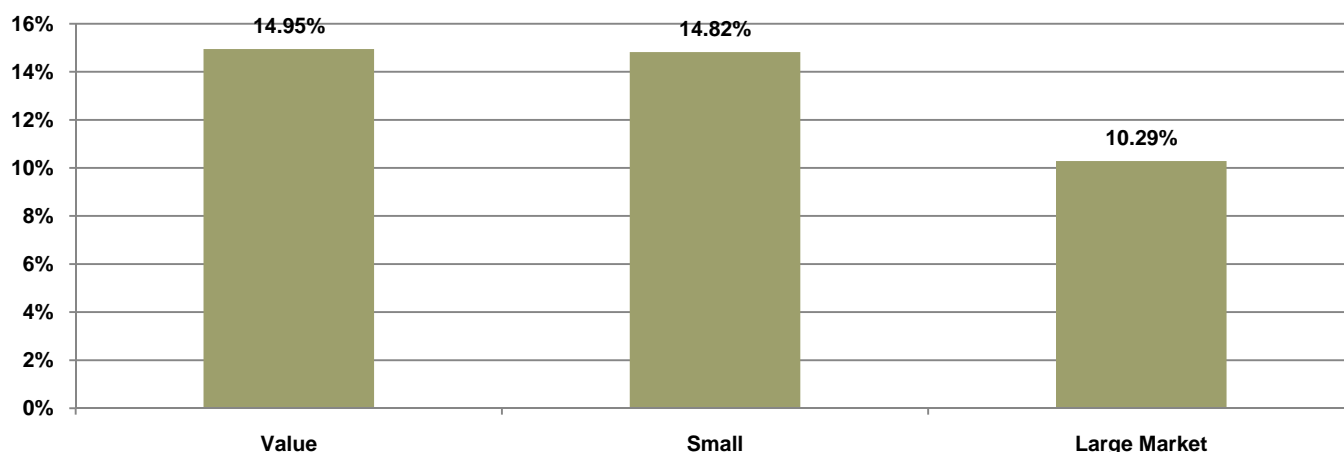
In the latest bear market, all the asset classes had negative returns in the same general magnitude. In the latest bull market, there is a wide range of returns. Perhaps the greatest contributor to the abysmal returns in the bear period was from panic when the entire notion of capitalism was shaken. Now that the panic has subsided, more normal correlations among asset classes have returned.

That brings us to fundamentals 6 and 5. Here is the latest long-term evidence to support having strategic "tilts" in your portfolio in favor of these documented sources of additional return:

**U.S. Indexes 1927-2008
Annualized Compound Return (%)**



International Indexes (Developed Markets) 1975-2008 Annualized Compound Return (%)



The evidence to support more than “market” allocations to small cap and value stocks is compelling in both domestic and foreign markets. To be sure, the additional return does not appear year in and year out, but it makes sense from a cost of capital standpoint. Small companies have a higher cost of capital than large companies and value companies have a higher cost of capital than growth companies. An investor is simply a provider of capital, so we’re entitled to that higher return for providing capital to those high cost of capital businesses.

Coach Lombardi was also quoted as saying “The difference between a successful person and others is not a lack of strength, not a lack of knowledge, but a lack of will.” As we have recently lived through one of the most tumultuous market events in our lifetimes, it has largely been those investors with the will to remain committed to a well thought out investment program that have limited their losses and indeed will prevail in the long run.

In summary, we stand pat on fundamentals 7, 6 and 5. Stay tuned for Part II in this series where will we address fundamentals 4, 3 and 2.

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and investment management firm in Florida.*



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