FREE LUNCH

A common expression in life is, "There's no such thing as a free lunch." In other words, it's virtually impossible to get something for nothing. However, in our approach to investing, there are a few "free lunches" that we're able to exploit and feed to our clients.

The first free lunch results from mixing two types of investments that generally do not move in the same direction at the same time. So, when one investment is "zigging," the other investment is "zagging," and the combination of the two results in a smoother ride. Combining two asset classes that don't travel the same path can also result in a higher expected portfolio return. The following is an example.

If we start with a portfolio that consists of 100% bonds and start adding a small dose of riskier stocks, the risk of the overall portfolio actually decreases and the expected return increases. Generally speaking, risk and return are highly correlated, so as you try to increase return, you inevitably increase risk. But in this case, we've added a riskier investment (stocks) to a 100% bond portfolio and reduced the risk of the overall portfolio, but increased expected return. This is the power associated with pairing two asset classes that don't move in tandem with each other. Free lunch number one has been served.

The second free lunch is similar to the first except it involves mixing domestic stocks and foreign stocks in such a way that results in higher expected return but lower risk than an all-domestic stock portfolio. So, even when you combine two "risky" asset classes, like foreign and domestic stocks, the riskiness of the overall portfolio can be reduced because of the correlation between the two asset classes. Again, this is the benefit of combining two asset classes that don't move in lockstep with each other. The optimum mix varies a bit from year to year but hovers around 2/3 domestic stocks and 1/3 foreign stocks. Free lunch number two is ready. We may have to create a frequent dining card.

The third free lunch is derived from our philosophy on bonds. We believe in using only short-term, high-quality bond mutual funds in our portfolios. Traditional fixed-income portfolios use a blend of short-term, intermediate-term and long-term bonds. As we have seen of late, when interest rates go up, bond prices go down. And, the longer the maturity of the bond, the greater negative impact on the bond price when interest rates rise. It is our position that investors are not adequately compensated for the risk associated with longer-maturity bonds. However, investors are compensated for risk in the long term with stocks. So if a client is comfortable with the risk and return attributes of a "traditional" 60/40 portfolio, we suggest implementing that allocation by tilting the portfolio slightly more to stocks. So a 60/40 portfolio becomes a 70/30 portfolio – 70% in equity and 30% in short-term high quality bonds.

Because we are using only short-term, high-quality bond funds, we have greatly reduced the risk from interest rate gyrations. In addition, the added dose of stocks produces a higher return over time. Over all ten-year periods where the information is available, our 70/30 portfolio has produced a higher return with lower risk than the traditional 60/40 portfolio. Let's just call this dessert.

The free lunches described above are commonly referred to as the "Modern Portfolio Theory" approach to investing. Regardless of the name, its implementation in our portfolios enables our clients to be on the receiving end of the ever-elusive free lunch. Is anybody hungry besides me?

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301 East Pine Street | Suite 300 | PO Box 4930 | Orlando, FL 32802-4930
(407) 422-0252 | (800) 448-0252 | Fax (407) 649-8795 | **resourceconsulting.com**