

Spring 2010

Diversification Still Makes Cents

Over the past 18 months, we've all seen the market behave in very unusual ways. At times, it seemed as though all investments except Treasury bonds could move in only one direction – down.

Having a mix of asset classes in your portfolio was supposed to protect you in all markets because the different types of investments weren't all supposed to move in the same direction at the same time. Maybe riskier assets like real estate could plunge, or equities could take a dive, but the broad-based decline surprised many investors – and experts.

People began to wonder whether diversification still provided any benefits.

Take the Long View

Our view has always been that the longer-term benefits of investment diversification tend to outweigh shorter-term market behavior. We still believe that diversification is a critical component of long-term investment success.

Many types of investments dropped in tandem during the crisis, some investments in sectors such as real estate suffered permanent losses, and investors in equities and high-yield bonds went for a wild ride.

However, most investments have since regained significant value – even though the economy is still troubled and we are certainly not out of this economic cycle yet.

The recent credit crisis does not disprove the value of diversification, and it may serve to remind investors of several important points:

- It's important to stay the course. The benefits of diversification are most likely to be realized over a complete economic cycle, incorporating periods when asset classes move up and down at different rates at different times, or when some of them may indeed move in the same direction at the same time.
- No matter how carefully one attempts to estimate the risk of any investment, actual market performance is impossible to predict. Even relative risk is difficult to predict.
- Diversification aims to maximize return and minimize volatility by investing in different types of assets that are expected to react differently to the same event. For a short period, most assets reacted the same way to the crisis. This can happen.
- A portfolio should contain a mix of assets, but that mix should adapt to changing circumstances. Today's winners may be tomorrow's losers.

Diversify Broadly

We believe that portfolios should be diversified not only among asset classes (e.g., stocks, bonds), but also within asset classes. We apply our macroeconomic perspective to fine tune the exposures.

We limit exposure to any particular economic sector, market capitalization level, geographic area, investment manager, or investment strategy. We consider the risk posed by changes in factors such as inflation, currency, interest rates, and corporate earnings because they can affect multiple asset classes. For example, in a weak corporate earnings environment, we favor exposure to high-quality companies that have strong market share, low debt levels, and a proven record for consistent earnings during tough times. In a weaker economy, we up the credit quality of our fixed-income allocation in an attempt to avoid companies or entities that might default on debt obligations.

We sometimes recommend alternative investments for added diversification, but not all clients qualify or are willing to accept the risks associated with non-traditional investment strategies. Your investment advisors can help you determine if alternative investments are right for you.

For an illustration of how diversification can smooth out the variability of a portfolio, please see the chart below. It focuses on equity diversification, but the same concepts apply to all asset classes.

Not as Easy as It Looks

Some of our clients tell us that they are diversifying risks by spreading assets across several investment managers. One problem with this approach is that it is difficult to understand the overall picture. You could have significant overlap that could result in unexpected company-

specific, economic-sector, manager-specific, or asset-class risks. We can help clients by doing a “look-through” of their investments with other firms to determine what the real exposures are, and we frequently find concentrations that are not apparent on the surface. With this information, the overall portfolio can be adjusted so that it actually is well diversified.

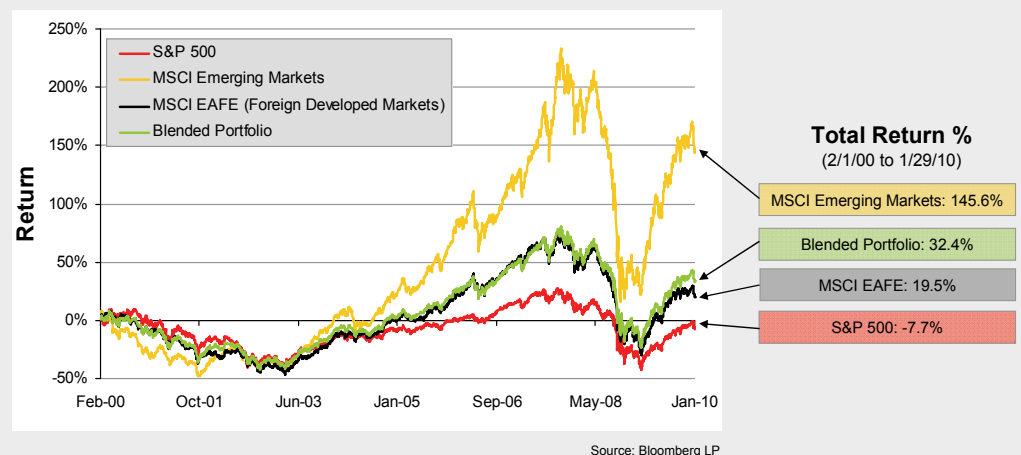
Other clients enjoy picking individual stocks. We certainly understand the appeal of investing in companies that you believe have strong growth prospects – examples that come to mind include Google and Apple. What concerns us is that by investing in individual companies, you may be exposing yourself to non-systemic risk (a risk not posed by the market in general) – in this case, company-specific risk.

A well-diversified portfolio aims to minimize company-specific risks so that the remaining risk in your portfolio is primarily the broad risk of the overall markets. This is known as “systemic risk” in the jargon of this business. Systemic risk is, by definition, a risk that cannot be eliminated through asset diversification, such as major business cycles, political instability, war, and social unrest. While you can attempt to mitigate systemic risk by hedging investments (sort of like betting on both sides), hedges themselves are not impervious to a catastrophic financial collapse – think AIG without the government bailout.

Another factor to consider in diversifying your investments is your non-marketable assets, such as real estate holdings or a proprietary business. You don’t want to

Capturing Growth, Limiting Volatility

In this chart, we compare the individual performance of three equity indices over the last 10 years, and then we show how a portfolio combining the three would have behaved. The blended portfolio is made up of 50% domestic stocks (S&P 500 Index), 25% foreign developed stocks (MSCI EAFE Index), and 25% emerging markets stocks (MSCI Emerging Market Index). The emerging markets component boosts the return of the blended portfolio, while the domestic and foreign developed components hold down the volatility. We do not believe that it is wise to overweight emerging markets, even though they are expected to grow more robustly – the greater volatility would subject our clients’ overall portfolios to an unacceptable level of risk.



inadvertently “double up” on risks already present in those assets. Illiquid and liquid assets should be considered together in evaluating your entire portfolio. Our advisors use planning questionnaires to better understand your overall financial picture so that they can help you develop an overall investment strategy suitable for your needs and objectives.

An Ongoing Process

The market is not static and neither is your life. We can alter the composition of portfolios to reflect our macroeconomic views and the realities of the market, but we also need to know about any changes in your financial picture. We strongly recommend that you communicate with your investment advisor whenever something significant in your life changes, or appears likely to change, to evaluate whether you need to make changes in your investment strategy.

A well-thought-out portfolio is a critical element in meeting your investment objectives, and diversification is a key part of that process. The more asset classes and the more risk factors considered, the better the chance of delivering attractive risk-adjusted returns. Despite the high correlation that most asset classes had during the peak of the crisis, investors who stayed the course have realized the benefits of diversification

About the author: Richard Long is responsible for the implementation of Contango's investment strategies and manages the due diligence team. His background includes positions with private client groups at GAM USA Inc. and Robertson Stephens, Inc. Rich earned an MBA in finance and management from the UCLA Anderson School of Management and a BS in business from Lehigh University. He has earned the right to use the Chartered Financial Analyst designation.

Curmudgeon's Corner: A Bull Market in Taxes?

It's spring and taxes are in the air. Here are my curmudgeonly thoughts: It's been a crummy spring so far here in San Francisco (too much rain) and taxes are on the rise (too much government spending – and too few people paying taxes).

Taxes have been in a long-term bear market – at least for the wealthy – since the top marginal rate hit 91% during Eisenhower's presidency. I must admit, it's the only bear market I've ever enjoyed.

I'm going to make a bold call – a new bull market has begun.

Let us know what topics you'd like George Feiger to discuss on the monthly client call.

To catch up on past calls, go to www.contangoadvisors.com.

Taxes Going Up

The Bush tax cuts of 2001 and 2003 are set to expire at the end of 2010, and President Obama has said he wants the highest marginal income tax rate go back to 39.6% and the long-term capital gains rate to go back to 20%. He's also expected to let the 15% maximum tax rate on qualified dividends revert to a taxpayer's highest marginal rate. (Which makes me wonder – would that make large corporations more likely to use their free cash to buy back stock instead of boosting dividends?)

Medicare tax increases aimed at the wealthy were signed into law with the passage of the health-care bill in March. Beginning in 2013, singles earning more than \$200,000 and couples earning more than \$250,000 will begin paying an additional 0.9% to Medicare on wages (or self-employment income) beyond the 2.9% they currently pay. And it doesn't end with earned income. The 3.8% tax will also be levied on investment income for this group – all capital gains, dividends, interest, rental income, and royalties (any income that's not tax-exempt or in a retirement account). Ouch, that's real money.

Probably More to Come

The end of the Bush tax cuts and new Medicare taxes aren't going to dent our debt. With the federal budget deficit running at more than 10% of gross domestic product and with red ink as far as we can see, we'll probably be seeing more tax hikes.

A sharp reduction in government spending would help stave off higher taxes, but how much can spending be reduced, realistically? Or we could see tax revenues

soar with a spurt of old-fashioned economic growth – like the tech boom we saw at the end of the 1990s – but how likely is that in the near future?

Less desirable options include devaluing the dollar, as Argentina, Brazil, and Mexico have done countless times. That would effectively reduce the interest burden on all of those outstanding Treasury bonds, but our credit might never recover. Or we could sell assets – would the Chinese be interested in the Grand Canyon? Probably only if we include the mineral rights.

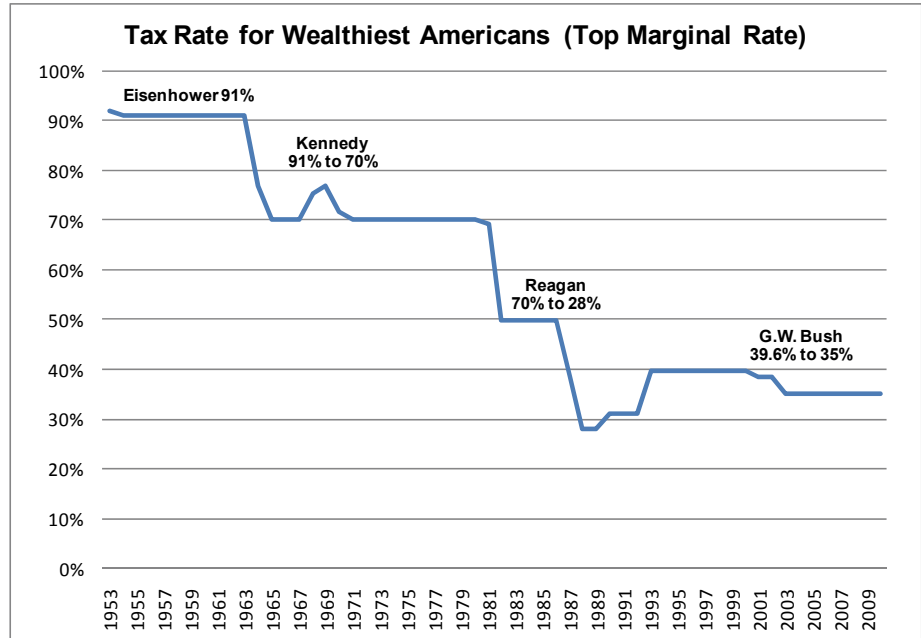
Other ideas include privatizing the post office, putting Amtrak out of its misery, downsizing NASA (again). You get the picture – we'll have to be creative.

We'll be hearing more about a value added tax (VAT). When House Speaker Nancy Pelosi broached the idea back in October, no one paid much attention to it. Now, though, the Democratic caucus is re-energized and a VAT has been endorsed by Paul Volker, the respected former Fed chairman. (A VAT differs from a sales tax in that it is incrementally added at each stage of a product's production and/or distribution.) Instituting a VAT would be complex and politically dangerous, so it's not likely to be seriously considered in 2010. After the midterm elections, it might be a non-starter anyway.

In Conclusion

Whatever we do, it seems increasingly likely that we'll see at least *some* additional tax increases in the years to come. The rich and the bankers are the most unpopular segments of our population now, so they may take the brunt of the load, but we'll all probably be affected. The deficit is just too big.

So what can you do to protect yourself from higher taxes? If you're not contributing the maximum to your 401(k), IRA, Keogh, or other retirement plans, you might want to. Converting to Roth IRAs might be beneficial. You may have deferred compensation plans available, or health savings accounts, or 529 plans for your children's future education. Seek sources of tax-exempt



Source: Tax Policy Center

income, like municipal bonds. Take a fresh look at defined benefit plans and charitable planning, and see whether estate planning could help you. You and your tax advisor can discuss what options may be right for you.

About the author: Perry Piazza is director of investment strategy, responsible for asset allocation and portfolio development. Previously, he held a number of trading-related roles in New York and London with Citigroup and Morgan Stanley. He earned an MBA from Yale and a BS from the University of Delaware.

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