**KOBREN INSIGHT MANAGEMENT**
An E*TRADE Wealth Management Company



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# It Pays To Have A Balanced, Diversified Portfolio

Greg Kelly

"At Kobren Insight Management we build balanced, diversified portfolios."

It is a message that is oft repeated in the writings of, and employed in the actions taken by the research team. While it is impossible to predict market returns, risk is considerably more predictable and manageable. By using diversified portfolios, we can appropriately mitigate the risk taken in a portfolio to match the individual risk tolerances of our clients. (For more on the importance of diversified portfolios, you can read Rusty Vanneman's article here.)

When allocating a portfolio, there are many variables that need to be considered. We have constructed these periodic tables with the hope that they will provide some color on the importance of diversification.

## Total Annual Returns of Key Indices

*Ranked in Order of Performance (Best to Worst)*

| 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* |
|---|---|---|---|---|---|---|---|---|---|
| Nasdaq 86.1% | REITS 25.9% | REITS 15.5% | LB Agg 10.3% | Nasdaq 50.8% | REITS 30.4% | MSCI EAFE 13.5% | REITS 34.0% | MSCI EAFE 11.2% | LB Agg 1.1% |
| MSCI EAFE 27.0% | LB Agg 11.6% | LB Agg 8.4% | REITS 5.2% | Russell 2000 47.3% | MSCI EAFE 20.2% | REITS 8.3% | MSCI EAFE 26.3% | Nasdaq 10.7% | Cash 1.0% |
| Russell 2000 21.3% | Cash 6.3% | High Yield 5.3% | Cash 1.7% | MSCI EAFE 38.6% | Russell 2000 18.3% | Balanced Portfolio 5.2% | Russell 2000 18.4% | LB Agg 7.0% | High Yield (1.3%) |
| S&P 500 21.0% | Russell 2000 (3.0%) | Cash 3.7% | High Yield (1.4%) | REITS 38.5% | Balanced Portfolio 13.2% | S&P 500 4.9% | S&P 500 15.8% | S&P 500 5.5% | REITS (5.6%) |
| Balanced Portfolio 19.4% | Balanced Portfolio (3.5%) | Russell 2000 2.5% | Balanced Portfolio (9.3%) | Balanced Portfolio 29.8% | High Yield 11.1% | Russell 2000 4.6% | Balanced Portfolio 15.8% | Cash 4.8% | Balanced Portfolio (6.3%) |
| Cash 4.9% | High Yield (5.9%) | Balanced Portfolio (2.3%) | MSCI EAFE (15.9%) | High Yield 29.0% | S&P 500 10.9% | Cash 3.3% | High Yield 11.9% | Balanced Portfolio 2.7% | Russell 2000 (9.4%) |
| High Yield 2.4% | S&P 500 (9.1%) | S&P 500 (11.9%) | Russell 2000 (20.5%) | S&P 500 28.7% | Nasdaq 9.2% | High Yield 2.7% | Nasdaq 10.4% | High Yield 1.9% | MSCI EAFE (11.0%) |
| LB Agg (0.8%) | MSCI EAFE (14.2%) | Nasdaq (20.8%) | S&P 500 (22.1%) | LB Agg 4.1% | LB Agg 4.3% | LB Agg 2.4% | Cash 5.1% | Russell 2000 (1.6%) | S&P 500 (11.9%) |
| REITS (6.5%) | Nasdaq (39.2%) | MSCI EAFE (21.4%) | Nasdaq (31.3%) | Cash 1.05% | Cash 1.4% | Nasdaq 2.1% | LB Agg 4.3% | REITS (17.8%) | Nasdaq (13.2%) |

*Past performance is not indicative of future results.*     ** Returns through 6/30/2008*

The first chart is related to diversification by asset class. Over the past ten years, an equal-weighted, balanced portfolio has, at times, outperformed each of the key indices over a one year time frame. It has also underperformed each of the indices in other years, but the relative performance of the balanced portfolio has consistently generated returns that compete with all asset classes over the long-term while also reducing the volatility of the full portfolio.

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The investible markets are subject to reversion to the mean. In other words, a market will neither outperform nor underperform forever. The long-term performance trend of most markets is one of positive expectations. Short-term anomalies will eventually correct themselves. By mirroring this long term up-trend of the investible market as a whole, a balanced portfolio exhibits less risk than would otherwise be achieved by investing in only one asset class.

## Total Annual Returns of Morningstar Style Box Indices

*Ranked in Order of Performance (Best to Worst)*

| 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* |
|---|---|---|---|---|---|---|---|---|---|
| 52.5% | 24.6% | 18.6% | -8.2% | 52.6% | 24.3% | 16.3% | 25.8% | 19.7% | -5.0% |
| 46.8% | 23.2% | 14.6% | -10.0% | 48.9% | 24.0% | 11.5% | 21.2% | 12.3% | -5.2% |
| 42.6% | 18.7% | 6.0% | -12.4% | 42.6% | 23.6% | 10.1% | 20.0% | 11.1% | -5.6% |
| 17.8% | 14.8% | 5.1% | -14.2% | 40.0% | 19.1% | 7.0% | 18.8% | 8.6% | -7.7% |
| 16.7% | 5.7% | -3.4% | -15.0% | 38.7% | 15.5% | 6.3% | 15.5% | 2.0% | -10.9% |
| 1.9% | 4.2% | -12.9% | -23.8% | 35.9% | 14.0% | 5.8% | 14.7% | -0.4% | -11.3% |
| 0.6% | -11.1% | -14.3% | -32.5% | 30.6% | 14.0% | 5.1% | 10.0% | -5.4% | -13.0% |
| -5.2% | -12.1% | -21.6% | -33.2% | 26.3% | 13.5% | 3.8% | 9.6% | -5.5% | -13.0% |
| -6.8% | -33.5% | -29.1% | -36.9% | 24.7% | 0.2% | 3.4% | 5.7% | -8.1% | -16.7% |

*Past performance is not indicative of future results.*    ** Returns through 6/30/2008*

- Large Cap Core = Morningstar Large Core Index
- Large Cap Growth = Morningstar Large Growth Index
- Large Cap Value = Morningstar Large Value Index
- Mid Cap Core = Morningstar Mid Core Index
- Mid Cap Growth = Morningstar Mid Growth Index
- Mid Cap Value = Morningstar Mid Value Index
- Small Cap Core = Morningstar Small Core Index
- Small Cap Growth = Morningstar Small Growth Index
- Small Cap Value = Morningstar Small Value Index

*Source: Morningstar Direct.*

When constructing a portfolio, it is important to consider the style and size of its holdings. While it is incredibly difficult to predict whether growth stocks will outperform value stocks, or small companies will outperform large ones, the Morningstar Style Boxes display the same mean reversion characteristics as the broader market.

Note that the top performing Morningstar style box has outperformed the bottom performing style box by an average of 32% since 1999. In only three of the last 10 years did the top performing style box finish the subsequent year with top quartile performance.

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## 3 ANALYST SPOTLIGHT

### Total Annual Returns of Morningstar Sectors

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* |
|---|---|---|---|---|---|---|---|---|---|---|
| Business Services | 9.3% | -14.1% | 3.4% | -24.0% | 27.1% | 15.3% | 16.0% | 13.4% | 13.8% | -8.5% |
| Consumer Goods | -8.1% | 5.2% | -1.4% | -4.1% | 22.2% | 11.9% | 2.1% | 17.6% | 11.3% | -12.7% |
| Consumer Services | 11.5% | -12.8% | 10.4% | -21.0% | 35.5% | 17.3% | 2.0% | 11.0% | -5.2% | -11.4% |
| Energy | 17.9% | 24.5% | -11.3% | -13.8% | 25.5% | 33.0% | 34.4% | 23.1% | 37.2% | 11.5% |
| Financial Services | 1.4% | 27.1% | -6.4% | -12.2% | 32.5% | 14.1% | 6.8% | 21.4% | -15.9% | -29.0% |
| Hardware | 81.1% | -31.1% | -32.9% | -41.3% | 65.3% | -3.8% | 2.5% | 9.1% | 16.9% | -13.4% |
| Healthcare | -6.4% | 38.1% | -11.8% | -21.4% | 19.1% | 3.9% | 8.2% | 7.9% | 9.6% | -13.0% |
| Industrial Materials | 19.8% | -0.6% | -7.5% | -23.3% | 35.9% | 18.8% | 2.9% | 17.7% | 20.5% | -12.1% |
| Media | 53.0% | -35.2% | -9.4% | -30.7% | 32.2% | 4.7% | -11.0% | 22.1% | -12.9% | -12.9% |
| Software | 97.0% | -46.2% | -16.8% | -32.5% | 23.1% | 10.8% | -2.7% | 17.6% | 15.8% | -13.8% |
| Telecom | 17.8% | -41.2% | -17.9% | -34.9% | 9.0% | 18.0% | -2.4% | 35.6% | 11.2% | -17.8% |
| Utilities | -11.2% | 55.5% | -26.5% | -19.8% | 25.0% | 23.4% | 14.8% | 24.8% | 18.2% | -4.7% |

*Past performance is not indicative of future results..*

** Returns through 06/30/2008*

Best Performing Sector

Worst Performing Sector

In addition to style and size, diversification of sector allocation can prevent a down year in one segment of the market from dragging down an entire portfolio. Any investor who put a lot of money into technology in late 1999 or 2000 is probably well acquainted with the dangers of investing without sector diversification!

An interesting point related to sectors is that they perform differently in up- and down-markets. A 2006 study found that in times of economic crisis, the relationship between sector returns become less correlated.[1] As we're presently seeing, the risk-reduction benefits of diversification actually increase in a bear market.

[1] Beine, Preumont & Szafarz, "Sector Diversification During Crises: A European Perspective," May, 2006, DULBEA Working Paper Series

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## Total Annual Returns of MSCI Indices

*Ranked in Order of Performance (Best to Worst)*

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* |
|---|---|---|---|---|---|---|---|---|---|---|
| 28.5% | 70.3% | 5.3% | 11.6% | 16.2% | 87.6% | 39.4% | 50.0% | 82.9% | 66.2% | 9.3% |
| 24.1% | 67.6% | -7.5% | 5.9% | -5.0% | 73.5% | 34.5% | 49.2% | 46.3% | 50.4% | 4.2% |
| 19.9% | 67.4% | -8.4% | -0.6% | -6.2% | 60.7% | 28.5% | 34.0% | 43.2% | 41.1% | -3.0% |
| 18.0% | 61.5% | -11.7% | -2.6% | -6.4% | 55.8% | 25.6% | 28.3% | 33.7% | 39.4% | -5.5% |
| 5.0% | 60.0% | -14.2% | -9.9% | -10.3% | 54.6% | 22.2% | 26.8% | 32.7% | 30.7% | -11.0% |
| -6.2% | 53.8% | -15.4% | -11.5% | -13.2% | 50.3% | 20.9% | 25.5% | 32.2% | 29.6% | -11.0% |
| -6.8% | 42.6% | -16.7% | -14.0% | -14.0% | 45.8% | 20.2% | 19.8% | 32.0% | 25.7% | -11.2% |
| -12.4% | 27.0% | -19.4% | -19.9% | -15.2% | 38.6% | 19.6% | 13.8% | 30.6% | 13.9% | -11.7% |
| -27.7% | 20.9% | -28.2% | -20.4% | -15.9% | 38.5% | 15.9% | 13.5% | 26.3% | 11.2% | -11.8% |
| -38.1% | 15.9% | -30.1% | -21.4% | -18.4% | 35.9% | 14.8% | 9.4% | 17.8% | 8.4% | -12.4% |
| -43.8% | 12.4% | -30.6% | -24.7% | -21.5% | 32.1% | 11.9% | 7.4% | 15.7% | 5.1% | -22.0% |
| -57.6% | 9.9% | -41.9% | -29.4% | -22.5% | 31.1% | 1.9% | 6.1% | 6.2% | -4.2% | -26.3% |

*Past performance is not indicative of future results.* ** Returns through 6/30/2008*

- MSCI Canada
- MSCI Pacific Ex Japan
- MSCI Europe
- MSCI UK
- MSCI Emerging Markets
- MSCI EM Asia
- MSCI EM Eastern Europe
- MSCI EM Latin America
- MSCI Japan
- MSCI China
- MSCI EAFE
- US Russell 3000

*Source: Morningstar Direct.*

Investing internationally provides yet another opportunity to lower overall portfolio volatility. This is because international equities do not correlate perfectly with domestic equities. This is partly a result of companies in other countries responding to a different operating environment (different consumers, different government regulations, etc.) but also because investing internationally diversifies a portfolio's currency exposure into currencies other than the US dollar.

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## 5 Analyst Spotlight

### Total Annual Returns of Commodities

*Ranked in Order of Performance (Best to Worst)*

| 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| 112.5% | 319.7% | 14.6% | 86.3% | 133.1% | 67.6% | 82.6% | 154.5% | 76.7% |
| 109.1% | 113.5% | 7.0% | 57.3% | 75.4% | 42.8% | 50.8% | 126.2% | 57.2% |
| 35.3% | 38.4% | 5.7% | 25.6% | 51.1% | 41.3% | 40.5% | 80.9% | 42.7% |
| 34.3% | 37.4% | 3.4% | 24.8% | 35.6% | 33.6% | 39.8% | 61.4% | 34.3% |
| 31.9% | 13.3% | 2.5% | 21.5% | 34.6% | 26.0% | 36.5% | 47.7% | 31.0% |
| 26.8% | 12.5% | 0.4% | 12.8% | 34.5% | 23.5% | 29.2% | 46.4% | 29.1% |
| 21.2% | 4.7% | -9.8% | 12.5% | 29.2% | 14.9% | 17.9% | 37.2% | 18.1% |
| 19.7% | -1.5% | -17.6% | 5.1% | 24.3% | 5.9% | 16.2% | 31.2% | 16.7% |
| 6.9% | -2.0% | -19.2% | 3.5% | 19.4% | 5.5% | 12.7% | 24.2% | 14.7% |
| -0.1% | -3.8% | -22.0% | 0.5% | 18.0% | -0.7% | 10.3% | 23.2% | 10.4% |
| -3.8% | -5.5% | -24.8% | -2.4% | 16.0% | -3.6% | 5.4% | 17.1% | 6.1% |
| -4.2% | -14.5% | -26.0% | -15.4% | 4.4% | -10.3% | 4.2% | 0.0% | -16.7% |
| -10.1% | -16.0% | -54.1% | -16.4% | 4.2% | -16.8% | -7.3% | -25.2% | -23.6% |
| -24.1% | -17.6% | -73.7% | -45.9% | -18.7% | -18.4% | -10.1% | -43.9% | -47.1% |

*Past performance is not indicative of future results.* *Source: Steele and US Global Research*

Aluminum
Coal
Copper
Corn
Crude Oil
Natural Gas
Nickel
Palladium
Platinum
Silver
Gold
Lead
Zinc
Wheat

We recently heard from the commodities trader Victor Sperandeo. In response to the recent headlines about corn, wheat, oil, and gold prices, he made sure to note that unlike equities, commodities are so-called substitution products. If the price of one good goes up, consumers will use less or find an alternative.

Again, it is extremely difficult to predict what the returns will be in these markets, and the returns can be incredibly volatile. For instance, compare an equal weighted portfolio of the top three performing commodities in 2006 vs. 2007. The 2006 portfolio would have seen returns of 119%; however, the same basket of commodities would have lost 18% in 2007. Over the same two year period, an equal weighted portfolio of all twelve commodities returned 41% and 18%, respectively. In the end, a diversified portfolio may give up some ground against a particularly hot sector, but it is stubborn when the sector cools, and another takes off.

The benefits of diversification are twofold. First, by maintaining investments in a variety of asset classes the pitfalls of performance chasing can be avoided. The periodic tables paint a compelling story of the variability and unpredictability of the market. Second, investing is an imperfect science, and there are bound to be missteps. Diversification mitigates the effects of making a big mistake, while participating in the long-term growth of the global capital markets.

Bottom line: Over the long-term, it pays to have a balanced, diversified portfolio.

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