When Diversification Does Not Work

May was a very challenging month for investors. Almost all investment sectors experienced large declines and that consumed a large portion of year-to-date portfolio gains for 2012. The S&P 500 lost (6.27%) and the largest "balanced fund" (*the conventional bond & stock approach*) was down nearly (4.5%) last month.

As we look back at the month of May and compare its performance to September of 2011, there are many similarities as you can clearly see from the chart below. Nearly all catalyst categories were down over both time periods with the exception of Vista's Protection Allocation. This naturally leads to questions including:

- ***What is an investor's truly wise decision and action when diversification does not seem to be working?***
- ***What is the wisest action to be taking right now?***

Description	*Sept 2011*	*May 2012*
Fixed Income	(1.12%)	(0.48%)
Foreign Bonds and Currencies	(6.64%)	(4.07%)
International Equities	(13.22%)	(10.78%)
Domestic Equities	(8.93%)	(6.46%)
Portfolio Protection Allocation	3.57%	6.90%
Real Estate	(15.04%)	(5.89%)
Energy, Commodities & Nat'l Res.	(15.95%)	(12.45%)
Precious Metals	(16.03%)	(8.56%)

Even though we naturally want to make changes when results are not positive, this is absolutely a time to "stay the course" and remain fully diversified. That has never been more important than today. Those who take any other approach expose themselves to increased risk in many ways - the most immediate risk is making a portfolio allocation shift at the worst possible time. Just as we saw late last year, we are surrounded by negative news and pessimism. Oddly, those are the conditions that historically have set the stage for excellent long-term periods of very positive returns. In summary, those who stay the course will be rewarded richly.

We are doing the <u>right</u> thing. We are doing the <u>wise</u> thing.

Is there a legitimate reason to be optimistic about portfolio returns in this environment? Only one answer is valid in our opinion. The diversification strategy we implement has had only 5 negative years in the past 42 years (last year being one of those) and the **average <u>annual</u> return in the 5 years following those negative years in the past has been 13.5%.** ***That means that investors almost doubled their portfolio values in the 5 year period following a negative year.*** While we know we cannot predict the future, we also know that history repeats itself and is our best teacher. History indicates we should be optimistic about the returns we expect in the next 5 years.

Taking a different view of this decision about maintaining diversification - ask yourself what would have to happen for a more "targeted" or a less diversified approach to outperform a fully diversified strategy over the long term. Two key points emerge as you examine the answer to this question. One is that you would have to be simply lucky to select the best one or two categories over a period of years in the future (especially since some unexpected event could totally change which categories outperform). The second key point is that specific categories have historically outperformed the average for only a few years - then underperform for a period of time. (See "*Vista's Periodic Table of Performance" on our website under Performance for a visual representation of this point*)

While the topic of wise investment strategy seems complicated on the surface, it can actually be condensed to three approaches or three choices that any investor faces. Those choices are:

a) Take a very broadly diversified investment approach and stay with your strategy long-term (through the ups **<u>and</u>** the downs) and realize the average return of all investments over the entire period you are investing for your retirement.

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- This avoids the huge losses that can occur when your portfolio is concentrated in only a few investments plus also provides protection against adverse conditions that might develop such as high inflation, etc.

b) Take a targeted approach or combination of targeted approaches (each and every type of "targeted investment strategy" offered by a hedge fund or mutual fund, etc. has risk exposure directly relative to how targeted or concentrated the strategy happens to be - this risk exposure is further compounded by leverage if the strategy uses leverage). The most common example of a "targeted strategy" is the Balanced Approach - the combination of stocks and bonds. This is what most investors do. They have extreme exposure to rising inflation and higher interest rates as evidenced by the returns realized during the 1970's for "balanced strategies."

c) Market-timing - trying to accurately "time" your investment moves in & out of the markets. Almost all investors attempt market-timing at some point in their investing lives. Countless articles and books have been written proving that "market-timing" never works over the long-term yet there is no amount of logic or mathematical proofs that can ever defeat the human nature desire to gamble and win. The other side to market-timing that gets little attention is the fact that investors who act based on fear and either exit their strategies for another approach or "go to cash" are also practicing a "market-timing" approach. As humans, we tend to panic at the worst possible time. This has been documented time after time throughout history. Those who finally abandon ship usually do so right before the calm seas return!

We want to reemphasize a statement we made in the Client Update in September 2011:

"Our current portfolio allocation is exactly where we fully believe we should be and we are positioned to prosper when market performance reverses. We are also assured that the defensive performance our diversification provides - which we value and have become accustomed to - will return in the near future."

This statement is as true today as it was in September of last year. Thank you for your continued trust in Vista Financial Advisors. If you have any questions you wish to discuss or would like additional information on Vista's 2012 Portfolio Allocation, please feel free to call (904) 880-8010 and we will be happy to review these questions or concerns with you personally.

The Vista Team

* *Thoughts and Insights of Bob Jackson, Chief Investment Strategist as summarized by Diana Folino, COO*