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INVESTOR EDUCATION SERIES

When “Beating the Market” Isn’t the Point

Many investors gauge their advisor’s value by comparing their portfolio’s performance to “the market”. Often, the market—which is generally understood to be the Dow Jones Industrial Average or the S&P 500 Index—outperforms a professionally managed broadly diversified portfolio.

Needless to say, this gives many investors pause, or maybe even heartburn at times. Here’s what’s important to remember:

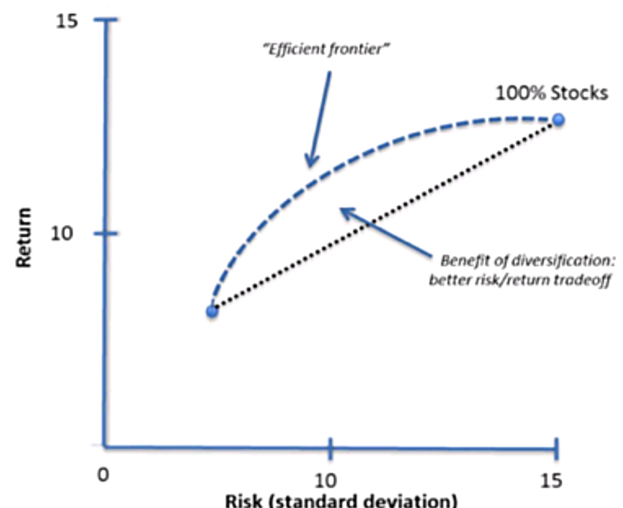
Your advisor’s job is to move you along the road to your long-term goals and to help you avoid the dangers when it gets bumpy along the way.

One way to achieve this is through diversification. In an investment portfolio, diversification means that different investments perform differently at different times. A long-term portfolio is a surgically crafted, diverse mix of stocks, bonds and other instruments, each counterbalancing each other to offset risk and capture returns. Your portfolio didn’t match the latest “market” rally? If you’re a long-term investor, that’s probably a good thing.

Indexes like the Dow and the S&P, on the other hand, are the very definition of blunt instruments. Both indexes measure stocks exclusively — not bonds, mid-sized companies, small caps or any other asset class such as REITs, commodities and international equities. They gauge only stocks in the U.S. market and only a small sample of the largest companies.

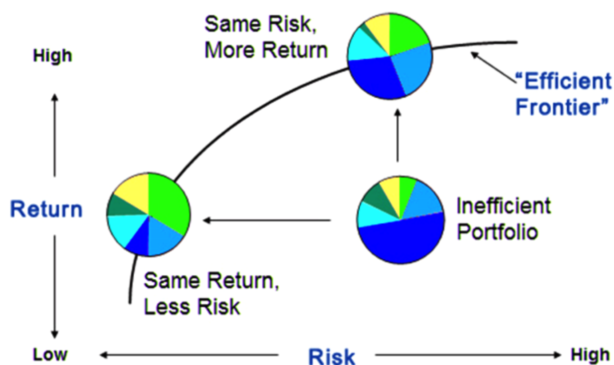
As we’ve seen lately, any single, non-diversified benchmark can fluctuate wildly, creating losses that are difficult to recover from. Diversified portfolios are designed to help cushion against extreme losses. When they’re successful, you end up spending less time recouping losses and more time making new money.

In building long-term portfolios, a good advisor is guided by the principle of the efficient frontier. The research and math behind this approach allows the advisor to assemble diverse investments that have the potential to generate return but are less likely to move in lockstep when markets are volatile. The long-term result is the ability for a portfolio to achieve a desired return with less risk.



Source: Morningstar Direct, January 1, 1976 through February 28, 2015

Efficient frontier portfolios aren’t designed to outperform, or even match, the Dow or the S&P in rising markets. They’re meant to lose less when these benchmarks are falling.



Remember that recovering from a 20% decline requires a subsequent 25% gain, overcoming a 50% decline requires a 100% gain and recovering from a 75% decline (think tech stocks in 2002) requires a 300% gain. In short, your portfolio and those one-dimensional "market" indexes are apples and oranges. Comparing them isn't very fruitful.

Now, how do you evaluate your portfolio's performance? The best way to start is by looking at the origin of that portfolio. At some point, you sat down with your advisor and laid out your unique goals, needs, risk tolerance and time horizon.

Your advisor built your portfolio based on that information. Efficient portfolios are goals designed to match your return and risk objectives.

Conservative investors should find themselves in the lower left hand corner in the above chart. Speculative investors are in the upper right hand corner (100% stocks). Which one are you? Once defined, your advisor should be able to show you clearly whether you are on track in reaching your goals. Investing is about taking risk. The most efficient portfolios include allocations to a broad set of diverse investment risks.

If you are a speculative investor, in makes sense to compare your highly concentrated stock portfolio to the Dow or the S&P 500 "the market". However, it makes little sense to compare your broadly diversified portfolio which may include stocks, bonds, real estate and other investment risks to "the market".

Encourage your advisor to help you determine where you fall on the risk/reward curve (the "efficient frontier"). If you would like an outside yardstick, ask your advisor to create a composite benchmark that reflects your total portfolio makeup. And remember that it's not necessary to beat your benchmark month in and month out to achieve your goals. Craft a well-thought-out investment plan and stick to the plan.

Want to know more? Contact Avi Rutstein, 610-989-9090 x 123 ***or*** avi@cmgwealth.com

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