Adviser Insight & Commentary

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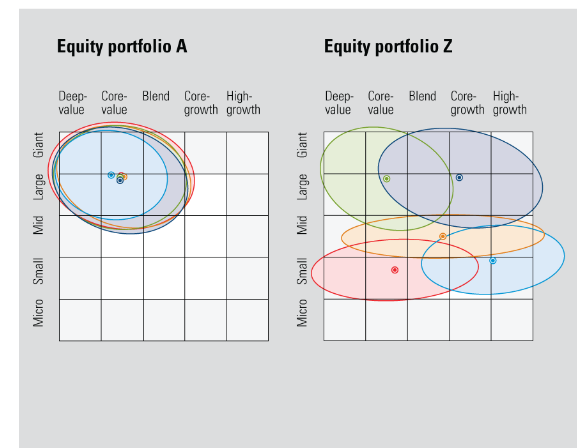
Exploration in Diversification

Investors seeking a well-rounded portfolio often wonder how many funds they need to reduce risk through diversification. The answer isn't a specific number of funds, but rather the holdings of each fund in the portfolio. If multiple funds in a portfolio have similar holdings, an investor can fail to achieve diversification benefits. Portfolio A and Portfolio Z in the image contain five mutual funds. Each oval represents the ownership zone, which accounts for 75% of the fund's holdings. The funds in Portfolio A overlap, indicating that each fund shares similar style characteristics. Too much overlap defeats the purpose of using multiple funds to create a diversified portfolio. Portfolio Z spans across many styles, so positive performance by some investments can neutralize the negative effect of others. As illustrated, it is important to be aware of the possibility of security overlap when constructing a diversified portfolio.

More Concentrated Portfolio Versus Diversified Portfolio



Diversification does not eliminate the risk of experiencing investment losses.

Source: Funds chosen from Morningstar's open-end database.

Mitchell, McLeod, Pugh & Williams, Inc. - Advisor Corner

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Welcome to the new format for our quarterly newsletter. We are excited about the change and hope you find it informative. In addition to a market commentary prepared by Morningstar, the newsletter will include articles of current interest about investment fundamentals.

Each quarter we will feature in this space either one of our shareholders or some information about our firm. We begin this quarter with Rick Mitchell. Rick is a founding member of the firm and serves as a Managing Director and as a member of the firm's Investment Policy Committee. He has been continuously engaged in the investment management and financial industry since 1978.

His clients include high net worth individuals, profit sharing and 401-(k) plans, trusts and estates and private foundations.

Rick is a graduate of the University of Alabama and of The College of William & Mary's School of Law; he is a member of the Virginia State Bar.

He is a native of Chapel Hill, North Carolina and has lived in Mobile since 1978.

Monthly Market Commentary

Recent economic updates revealed weaker retail sales, slowed employment growth, rise in initial unemployment claims, and weaker housing data after the expiration of the housing credit. Both existing home sales and new home sales performed below expectations. Durable goods orders, however, increased since April. Both the Consumer Price and Producer Price indexes showed sequential monthly declines, while industrial production experienced a monthly growth of more than 1%. A positive outlook of consumer income and spending along with manufacturing growth were the bright spots of recent reports.

Housing statistics: Housing statistics were down because of the expiration of the homebuyers' credit at the end of April. Housing statistics took a dip in May, declining by 10% from April's level to 593,000 units on a seasonally adjusted annual rate.

Industrial production: Industrial production was up 1.2% in May and up 7.6% from last May. Industrial production was aided by strong growth from the utilities sector. Manufacturing, the largest sector, grew by more than 1%, while only the construction sector grew by less than 1%.

Inflation: The overall inflation rate declined by 0.2% (2.4% annualized) in May after a 0.1% decline in April. On a year-over-year basis, prices were up a modest 2%. The bulk of the recent declines are due to falling energy prices that were helped along by stable housing costs.

Durable goods: Durables goods like cars, computers or televisions aren't consumed or disposed of quickly and are meant to last for a while. Total orders in this segment increased since April. Excluding the aircraft sector, durable goods sales grew by about 0.9% over April's results. On a year-over-year basis, orders were up about 18.5%, following a 19.4% year-over-year increase for April.

Employment: Private employment growth was higher in June than it was in May, but it was still well below April's construction-jobs-inflated employment growth. Private-sector employment grew by 83,000 jobs, compared with a more-meager 33,000 jobs in May. Headline job figures showed a decline of 125,000 as a result of the dismissal of 225,000 census workers. However, the number is still well shy of the 200,000-300,000 level that is typical of most recoveries, and it is still well below the 241,000 jobs gained in April.

Consumer incomes: On a more positive note, consumer incomes were up sharply in May. Real disposable income jumped 0.5%, on the heels of healthy gains of 0.3% and 0.6% in March and April, respectively. Compounding growth for those three months produces a very healthy 5.6% annualized growth rate. Given that the consumer represents more than 70% of the economy, these income figures could translate into better sales growth during the months ahead. Consumption expenditures grew by a healthy 0.3% in May following 0.4% growth in March, and no growth in April. But that 0.3% growth in consumption was far less than the 0.5% growth in spending causing the savings rate to jump to 4%, compared with 3.8% in April.

Quarter-end results: A faltering stock market, the European crisis, and continued tightening in China certainly didn't help the moods of consumers or investors during the second quarter. Temporary workers hired for the 2010 census and expiring housing credits have already complicated the interpretation of both housing and employment data and could continue to do so for another two or three months. Congress' decision not to extend unemployment benefits will be another complicating factor in the months ahead.

While consumer spending has recovered the ground that it lost, industrial production has recovered only half of what was lost. According to Morningstar economists, recent increases in new orders are supportive of future increases in industrial production, and this should eventually lead to further improvement in employment. An improving manufacturing economy should eventually lead to positive changes in the larger services part of the economy.

Investing with a Long-Term Focus

It's easy to follow a long-term investment strategy in good times; the hard part is sticking with it in bad. What should you do if you are a long-term investor sitting in the midst of a bear market? If you are holding a well-diversified portfolio, the answer is rather straightforward: stay the course.

Volatile markets can cause investors to abandon their long-term goals for risky short-term investment strategies. Volatility can range from a single-day market crash to extended periods of jagged performance. The market has undergone cycles with high and low annual returns from 38% (1995) to -37% (2008) over the past 50 years. It can be tough to stay the course in the face of such fluctuations.

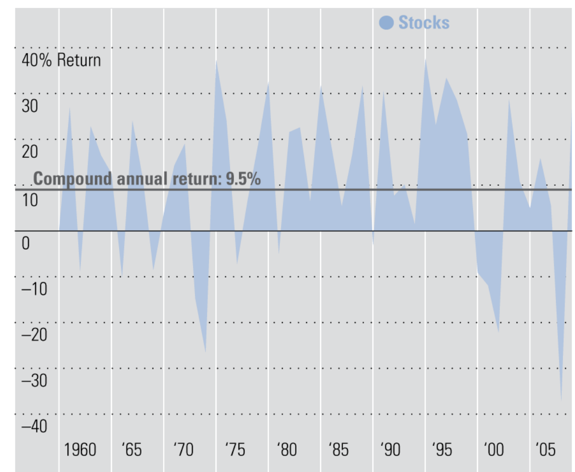
The graph illustrates the annual stock market performance since 1960. The bull market from 1991 to 1999 lasted the longest, with an average annual return of 21%. In contrast, a majority of the downturns shown in the image have lasted shorter periods of time. Despite the ups and downs over the years, the stock market generated an average return of 9.5% over this historical time period.

It goes without saying that the market will head south at times, but history shows that despite this, the market's long-term trend is upward. Consequently, the sooner an individual implements an investment plan, the better. By contributing early and as often as possible to such a plan, an investor's money compounds over time. Compounding is the ability of an asset to generate earnings from previous earnings, which serves to accelerate the growth of your assets as time moves on.

A disciplined investment approach is still the best strategy for handling market downturns. This includes maintaining a well-diversified portfolio and using dollar-cost averaging, instead of lump-sum purchases, to ease into new investments. Dollar-cost averaging involves the purchase of securities, usually mutual funds, in fixed dollar amounts at regular intervals. This strategy is maintained no matter what direction the market is moving. Finally, staying focused on a long-term investment plan may enable you to participate in recoveries.

Overall, the stock market has exhibited positive performance in the past, but be prepared for periods of underperformance. The fact is no one can predict market declines with any type of certainty. As a result, a portfolio consisting of both stocks and bonds can serve as a good strategy for short-term diversification. On the contrary, investors who have a larger appetite for risk may want to consider long-term investments in stocks. With a disciplined approach to investing, one may be able to take advantage of market rebounds and may enjoy superior returns in the long run. Don't be sidelined by market expansions and contractions.

Annual Stock Market Performance: 1960–2009



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general.

Dangers of Market Timing

Two of the most dangerous words in the investing world are “market timing.” Market timing occurs when investors try to predict which direction the stock market will head. While some investors have been known to make money timing the market, it is highly inadvisable for long-term investors to try this extremely risky strategy. Opponents of Market Timing: Most investors and academics believe it is impossible to forecast market movements. Such a technique amounts to gambling when compared to a sound investment approach. It fails far more than it works, and market timers often end up buying high and selling low. Furthermore, you run the risk of missing periods of exceptional returns. For example, over the past 20 years, a $1 investment in stocks, as represented by the Standard & Poor’s 500®, would have grown to $4.84. If that same $1 investment happened to miss the best 10 months of stock returns over the past 20 years, the ending value would have equaled only $2.04. This would have been less than the value for an investor in a 30-day Treasury bill, a.k.a. cash, $2.12. Only those who remained invested in stocks through the entire period were sure to get market exposure during the crucial hot months.

Advocates of Market Timing: On the contrary, a number of websites, newsletters, and other trading services boast they can time the market. While their returns may have in fact beaten the market by a considerable margin, it’s safe to assume that these systems can’t consistently hold up over the long term. On some occasions and during some stretches of time, market timing can help generate impressive profits. However, you must be familiar with the dangers behind such an approach.

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