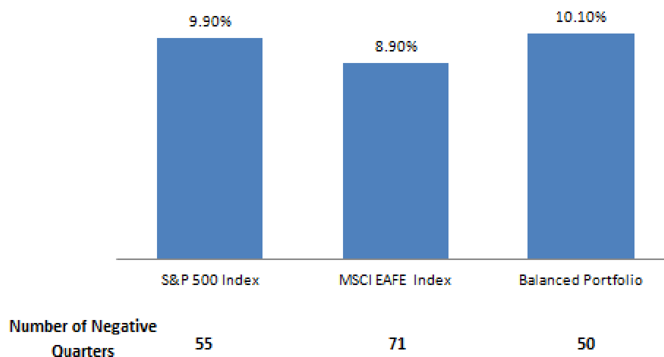
I'll Take the Free Lunch, Please

The origins of the saying "There is no such thing as a free lunch" allegedly refer to the once-common tradition of saloons in the United States providing a "free" lunch to patrons who had purchased at least one drink. Rudyard Kipling famously noted in 1891 that all the free foods offered were high in salt (e.g., ham, cheese, crackers), so those who ate them ended up buying a whole lot of beer.

We, too, are skeptical of the free lunch. In fact, only one free lunch persists in the arithmetic of finance: diversification. It is abundantly clear that prudent investing means not only capturing reliable sources of expected return but also managing diversifiable risks and eliminating risks that do not increase expected returns.

Annual Returns: 1970-2012



Avoidable risks include holding too few securities, betting on countries or industries, following market predictions, speculating in such areas as interest rate movements, and relying solely on information from third-party analysts or rating services. Diversification is an essential tool available to all investors, mostly free of charge. While it does not eliminate the risk of market loss, diversification does help eliminate the random fortunes of individual securities and position your portfolio to capture the returns of broad economic forces.

To demonstrate the "free lunch" of greater long-term returns with lower volatility, we will use the S&P 500 as a proxy for the US market in a diversified portfolio. Take, for example, a portfolio that holds just US stocks (S&P 500 Index), a portfolio that holds international stocks (MSCI EAFE Index), and a portfolio that holds both. As illustrated in the graph on the left,[1] not only has the diversified portfolio provided a higher historical return than either of the others alone, but also it has done so with fewer negative quarters.

These days, opportunities for global diversification within asset classes have declined due to increasing global correlation. This notion is confirmed in an empirical analysis of rolling three-year correlation among four regional markets: Europe, the US, Japan and emerging markets. These broad regional definitions should keep the correlation estimate low, yet the impact of increased globalization is clear, with average correlations increasing from 0.4 in 1980 to nearly 0.8 today. Put simply, compared to three decades ago, an investor must double the amount of international equity exposure to achieve the same level of diversification.

A portfolio that includes both US and non-US equity holdings certainly will not always outperform the US market. We should expect that there will be periods when the US dramatically outperforms the international market and vice versa. For example, the following table[2] shows that in the 10-year period ending December 31, 2012, the US ranked a lowly 39th out of 45 investable equity markets. It would have been easy to grow frustrated with seemingly persistent underperformance of the US relative to

other nations. However, if investors had cowed to that frustration, they would have missed out on the relative overperformance of the US market so far in calendar year 2013.

Ranking Markets Around the World
Ten-Year Performance in US Dollars
Annualized Returns Year Ending December 31, 2012

1. Colombia	16. Singapore	31. Austria
2. Peru	17. Sweden	32. Spain
3. Brazil	18. Denmark	33. United Kingdom
4. Indonesia	19. Malaysia	34. Taiwan
5. Egypt	20. Australia	35. Hungary
6. Thailand	21. Korea	36. Netherlands
7. Turkey	22. Russia	37. France
8. Philippines	23. Hong Kong	38. Belgium
9. Chile	24. Canada	39. USA
10. Czech Republic	25. Poland	40. Japan
11. Mexico	26. Morocco	41. Portugal
12. China	27. Germany	42. Finland
13. South Africa	28. New Zealand	43. Italy
14. India	29. Switzerland	44. Ireland
15. Norway	30. Israel	45. Greece

Diversification is only a free lunch if you are patient enough to calmly finish your meal.

Tell Everyone You Know

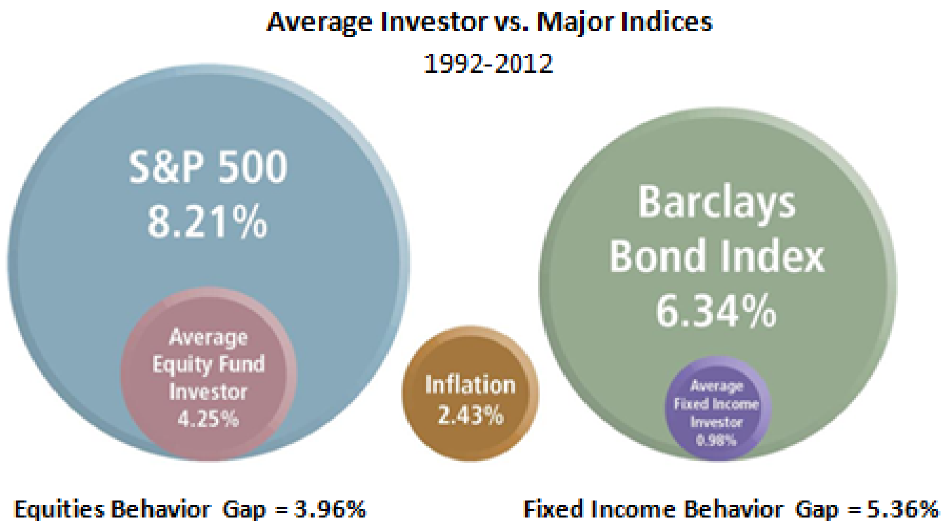
Within this quarterly piece you have read details about the science utilized in creating an investment portfolio optimized for balancing risk and return – but you will not find any in this article. Instead, here we'll discuss something much, much more important.

There is astonishingly good evidence that the average investor squanders roughly half of the market return to which he or she is entitled. What's worse, the mechanism for this systematic eradication of wealth is a series of rather common and quite predictable behavioral mistakes. Those persistent missteps include, but are not limited to, performance-chasing, speculative elation at market peaks and fearful surrender at market lows. In short, left to our own devices, we will do the wrong thing at the wrong time and for the wrong reasons.

Specifically, the data shows that investors can sabotage their returns when they fail to take a long-term perspective. Consider the chart on this page[3] which shows that over the last 20 years, the average investor did substantially worse than major indices. You should find the results nothing short of appalling. If you are the compassionate sort, you might even have a pang of pity for all those investors who took the risk but never captured the return.

The average equity investor in the study described above underperformed the S&P 500 by almost 4% each and every year. A behavioral gap that large can have a real impact over time on an investor's long-term goals – even quality of life. Amazingly, to improve investment returns by almost 400 basis points, all the average investor had to do was choose a middle-of-the-road mutual fund and lock it in a drawer for 20 years.

No matter how many times you check the market this week, how many economic prognostications you hear from gurus, or what your neighbor thinks the Fed will do – none of these will make you a better investor. In fact, all three (or any versions thereof) will conspire to corrode your discipline. Think of it as a dieter who is endlessly perusing a dessert tray. One of these times, you might give in and all your hard work will be for naught.



But do not fret, because you have a choice – and thankfully, it is a simple one. You can choose to follow the noisy short-term ups and downs of the market, or you can choose to acknowledge the absolute certainty that future short-term market movements are equally unknowable and unimportant. Choosing the former will put you at risk for the common behavioral mistakes that are certain to erode wealth, while choosing the latter will solidify the capital needed for your financial independence, your family legacy, and your societal imprint. Tell everyone you know – you just might save someone a few million dollars.

As purveyors of client advocacy, we are saddened to admit that many who work in the arena of giving "investment advice" are, at best, intermittently adequate at selecting investments – and much less so at delivering behavioral investment counseling. The problem is not that advisors and their clients are unintelligent; the problem is that they are deploying their resources in trying to solve the wrong problem. They are focusing evermore on analytical left-brain issues such as tweaking portfolios, rationalizing forecasts, or calculating short-term performance instead of focusing their collective efforts upon the mastery of behavioral finance.

There is astonishingly good evidence that the average investor squanders roughly half of the market return to which he or she is entitled.

Our vow to you is the same as it was the day we agreed to become client and advisor – that we will never become enablers or facilitators of sub-perfect investor behavior. We will take every opportunity to discuss these critically important concepts with you in both good and not-so-good markets. We'll make sure that you grasp them intellectually – but more important, that you meaningfully connect with them emotionally. **After all, our behavior is perhaps the single greatest determinant of our long-term investment performance.**

Welcome to the Rockwood Family

While some of you have had the opportunity to meet him, and others have read about his arrival, we here at Rockwood Wealth Management are thrilled to announce that Mark T. Kelly has joined us this May as a full partner and a primary client-facing advisor in our New Hope, Pennsylvania, office.

Prior to joining Rockwood Wealth Management, Mark enjoyed an 18-year career at some of the most well-regarded firms in the industry. His most recent experience as a wealth management practitioner includes a position as a Portfolio Manager at Hirtle, Callaghan & Co., where he worked with clients with a minimum of $10 million in investible assets.

More important, Mark is an ideal fit for the client-centric culture at Rockwood Wealth Management. He holds himself to the highest standards of personal integrity, possesses an unwavering work ethic, and delivers wealth management at the greatest levels of the profession – yet he does so with the humility befitting our organization and our clients.

Prior to his role as an advisor at Hirtle, Callaghan & Co., Mark served as a Director at Convergent Wealth Advisors and a Founder of Copper Beech Advisors.

He has extensive knowledge in all aspects of working with high-net-worth clients, including specialized expertise in investment management, strategic tax planning, and estate planning. He is a Certified Public Accountant with a master's degree in taxation, and he also holds the Chartered Alternative Investment Analyst designation.

Mark lives in Lansdale, Pennsylvania, with his wife, Michelle, and their two children. On the personal side – he enjoys the beach, swimming, traveling, and spending time with his family and friends.

Please join us in offering Mark and his family a heartfelt welcome to the Rockwood Wealth Management Family.

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Any performance data represents past performance. Past performance is no guarantee of future results, and current performance may be higher or lower than the performance displayed. The investment return and principal value of an investment will fluctuate such that an investor's shares may be worth more or less than their original cost.

[1]*Quarterly data: 1970–2012, rebalanced quarterly. The S&P data are provided by Standard & Poor's Index Services Group. MSCI data copyright MSCI 2012, all rights reserved. Results represent past performance and do not predict future performance.*

[2]*Source: Morningstar Direct 2013. Countries represented by their respective MSCI IMI (net div.). Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio. Past performance is not a guarantee of future results. All investments involve risk, including loss of principal. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting.*

[3]*Average stock investor and average bond investor performances were used from a DALBAR study, Quantitative Analysis of Investor Behavior (QAIB), 03/2013. QAIB calculates investor returns as the change in assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs. After calculating investor returns in dollar terms (above), two percentages are calculated: total investor return rate for the period and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions, and exchanges for the period. The fact that buy-and-hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future. S&P 500 and Fixed Income index returns do not include expenses and fees.*