BULLSEYE
Highlights

Portfolio Chemistry

American satirist Will Rogers once said, “I am more concerned with the return of my money than the return on my money.” This is true of many risk-averse investors who seek to find the right balance of risk and return from their investments. Unfortunately, many investors forget the element of risk when times are good and instead chase the high-flying performance of the stock market. But when the market turns downward, they realize they should have kept risk management in the forefront of their minds. So how can an investor find a healthy blend of risk and return? First, they need to understand their investment goals, risk tolerance, and time horizon. Then they need to build a portfolio that accurately reflects those objectives.

Through the use of diversification, investors can attempt to spread their investment risk across multiple markets to lower the combined risk of an overall portfolio. One way to effectively diversify is to combine less-volatile assets with riskier ones. That concept is fairly intuitive, not unlike the idea of adding cold water to hot water, resulting in warm water. Typically, this lukewarm risk control approach can result in watered-down returns because less risky investments often provide lower returns, on average. Using a blend of high-risk and low-risk investments may be fine for many people, especially those who are extremely risk averse and like-minded with Will Rogers. It explains why many investors turn to bonds to reduce the risks associated with stocks.

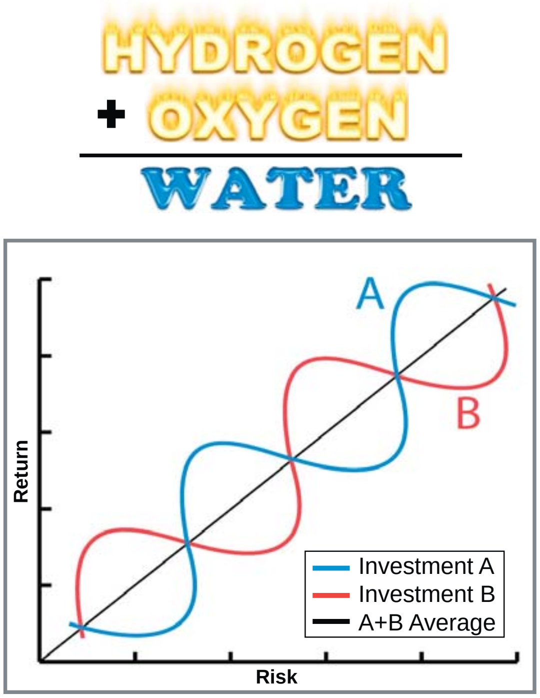
Another way to diversify is to combine additional volatile assets, provided that they are uncorrelated—meaning, investments that tend to move up and down at different times. This second type of diversification is less intuitive. How can you combine two risky assets and have less overall risk as a result? In this case, forget about hot and cold water. Instead, think about the water itself.

Hydrogen and oxygen are both highly flammable. But as you may recall from high school chemistry class, when combined, they make water (H^2O)–as illustrated in the first image to the right. In this case, two very volatile components are combined to form the extremely stable compound we actually use to put out fire.

The same could be said for combining some riskier investment assets. As long as two asset classes move in different directions at different times, they may stabilize one another, creating the potential for significant diversification benefits. This idea of offset correlation is illustrated in the second hypothetical image to the right.

For many investors, the core of their portfolio consists primarily of U.S. stocks because of the potential for strong long-term performance and ease of access. But stocks also have a well-known history of volatility, which makes some investors uneasy. When discussing portfolio management, standard deviation is often used as a measure of risk where

Blending Volatile Components To Reduce Risk

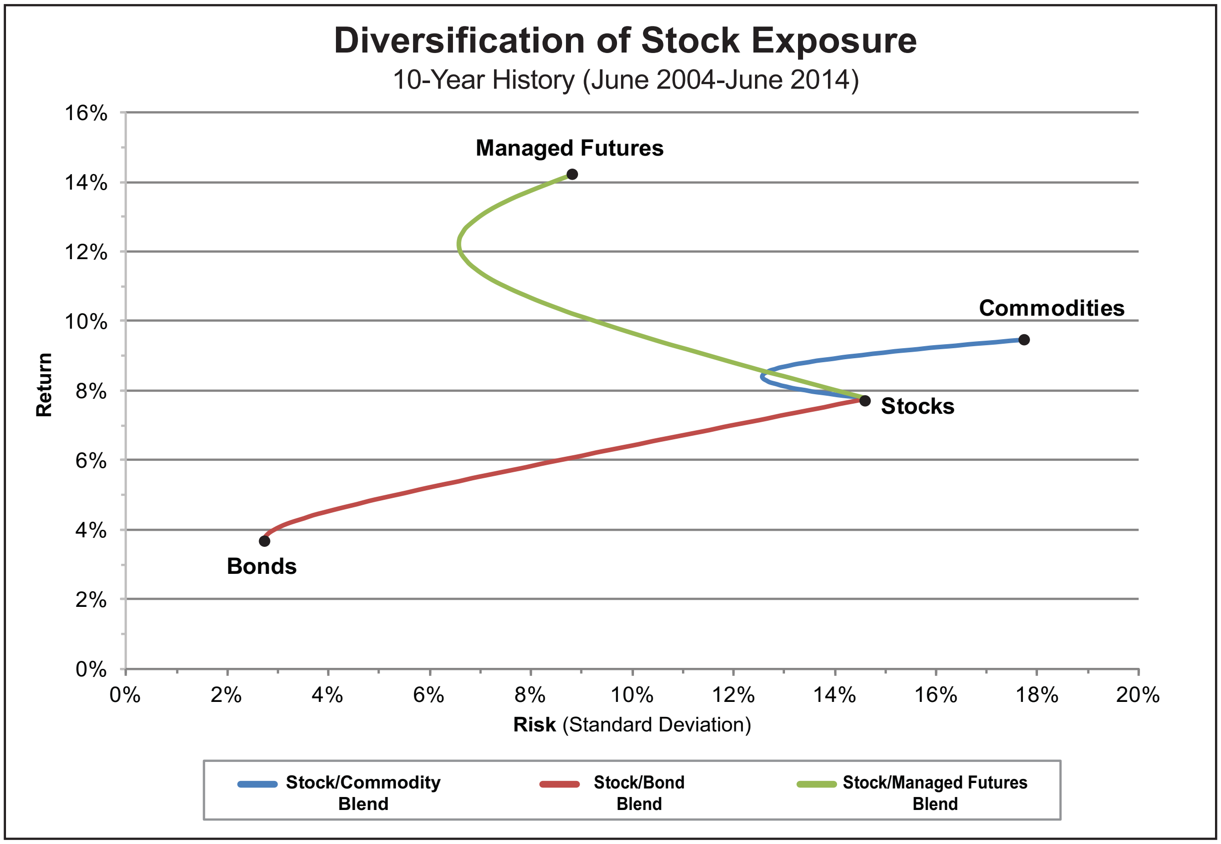


Hypothetical illustration, not intended to represent actual investments.

the volatility of an investment can be measured by the amount and frequency that the price moves up and down. For conservative investors who are seeking to reduce risk, bonds have historically been the diversifier of choice. But with interest rates near all-time lows, some investors are seeking alternative sources of return other than bonds. When income is not an objective, managed futures have provided an alternative source of lower-volatility diversification. The historic returns have been compelling, while also maintaining a low correlation to stocks and bonds.

A common comment about commodities is that they are too risky. But for investors with a longer time horizon, or for those with a greater risk tolerance, diversifying through the use of bonds may hinder the ability to generate the desired balance of risk/return. This is where the idea of combining other volatile, but non-correlated investments may make sense. An example might be commodities, which have risk-and-return statistics that seem even more volatile than stocks, but with a low historical correlation. Many investors find it hard to comprehend adding an investment with more historical volatility in order to help to reduce overall risk.

The graph below shows the 10-year historical risk/return averages. From the starting point of a 100% stock allocation, the three lines show incremental blended exposure to bonds (red) , managed futures (green) and commodities (blue). As the image shows, a stock investor could have added bonds to reduce risk, with a somewhat expected result of also reducing return. In retrospect, it would be obvious to most investors to see the potential benefit of managed futures because of the lower risk and higher returns. But it may not have been intuitive to see that allocating approximately 30% to commodities would have garnered similar risk/return characteristics to managed futures where the blue and green lines intersect. Again, because stocks and commodities often move up and down at different times, there can be significant diversification benefits resulting from the low correlation.



Past performance is no indication of future returns. *The graph above is based on annualized index data as proxies for stocks (S&P 500), bonds (Barclays U.S. Aggregate Bond Index), managed futures (A.I. Managed Futures Volatility Index) and commodities (Longview Extended Commodity Index). The index data and hypothetical blended portfolios assume reinvestment of dividends, but do not include fees. Indexes are not available for direct investment. Data sources: FactSet, calculated by Arrow.*