Simmons Wealth Advisory

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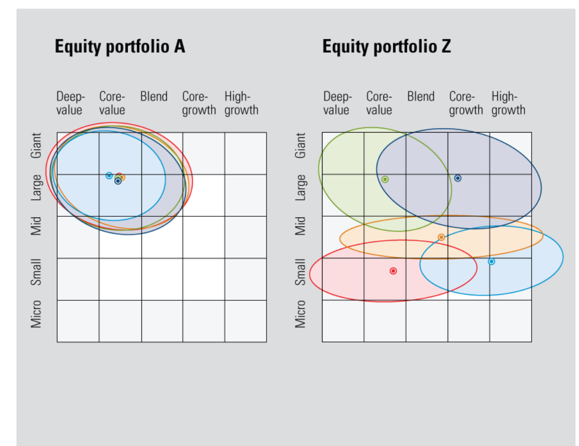
Exploration in Diversification

Investors 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. 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.

Advisor Corner

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A veteran in the industry, albeit a young one, Mark has developed a distinguished reputation for his approach to financial planning and portfolio management, which have become the foundation of the firm's core philosophy. He has received wide publicity for his investment insight and has been featured in numerous business publications.

A native of Baton Rouge, Mark received a B.S. in Business and Finance from Centenary College of Louisiana. Prior to founding Simmons Asset Management, he maintained positions such as Vice President, Portfolio Manager and Chief Compliance Officer as well as acquiring the Series 7, 24 and 66 licenses.

Mark made the decision to transform a lifelong career into helping people maximize their financial condition by reducing costly mistakes. He formulated Simmons Asset Management, a wealth management firm, whose main goals are to look out for the best interest of investors, while educating them at the same time.

Measuring Fear in the Markets

Fear is a basic emotion that all human beings experience when feeling threatened or uncertain. Fear can be caused by many things, from being afraid of losing a loved one, to being fearful of the ancient Mayan prophecies that predict the end of the world. Interestingly, an investor can also experience (and measure) fear in the stock market.

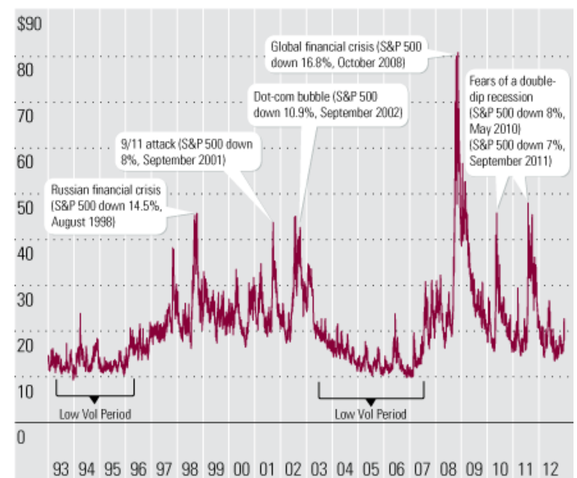
Fear in the market can be measured by the Volatility Index (VIX), also commonly known as the “fear index.” The VIX measures the uncertainty that investors feel about short-term market prospects. A period of high fear is characterized by higher uncertainty, higher volatility (stock prices swinging widely), and a higher VIX reading. On the other hand, a lower VIX reading occurs during less stressful periods because of lower uncertainty and lower volatility.

The image highlights the daily closing price of the VIX over the last 15 years. When there were sudden downturns that resulted in steep declines in the market, the VIX spiked sharply to reflect the uncertainties in the market. Examples can be seen during the Russian financial crisis in 1998, the 9/11 attack in 2001, and the dot-com bubble in 2002. More recently, the global financial crisis saw the S&P 500 decline by 16.8% in October 2008, causing the VIX to spike to an all-time high of $80. Concerns regarding a potential double dip recession in 2010 and 2011 also caused the VIX to rise. When times were good and the market grew complacent, the VIX was not as volatile. Instances of this can be seen throughout the 1990s, as well as during the period leading up to the global financial crisis from 2003–2007.

Why is fear so rampant in times of great uncertainty? It’s one thing to be afraid of what’s happening next in a stable market, but it’s a completely different story when you’ve just seen your portfolio shed 40% of its value and wonder what’s next. Investors understand that fundamentals advocate investing for the long haul, and avoiding market-timing pitfalls in the short-term. Yet they can’t help but be afraid, thinking about what would happen if they lost another 10% of their savings over the next month, next quarter, or next year. What if markets never recover and they never see that money again?

Investors who are faced with situations where they are fearful of market performance in the near future should take a step back and avoid making irrational investment decisions that may adversely impact their financial goals. Similarly, during calmer times, investors should not be lulled into a false sense of security and expect markets to only continue to rise forever. And for those investors saving for retirement, it is important to remember that short-term fear and volatility should not impact their decisions for the long term.

Daily Closing Price for the VIX



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. The S&P 500 index is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. The VIX is represented by the CBOE volatility index.

U.S. Stocks and Bonds Before and After Taxes

Even though investors don't always realize it, taxes can have a dramatic effect on an investment portfolio, especially in today's relatively uncertain tax environment. The tax law enacted in December 2010 was only intended to last for two years, and new changes may be effected in 2013.

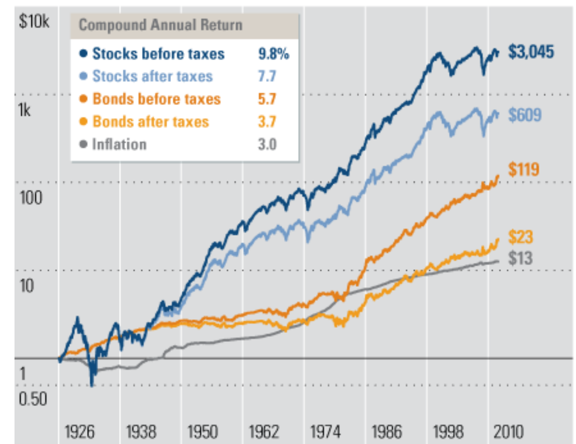
The image illustrates the hypothetical growth of inflation and a $1 investment in stocks and bonds before and after taxes since 1926. Over the long run, the adverse effect of taxes on investment returns becomes especially pronounced. Stocks are the only asset class depicted that provided any significant long-term growth. After considering taxes, government bonds barely outperformed inflation over this time period. In a world with taxes, focusing on fixed-income assets alone has not provided investors with a substantial increase in wealth. If you desire substantial after-tax growth, you may want to consider a larger allocation to stocks. Another alternative, if you are able, is to consider tax-deferred investment vehicles.

Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed. Stocks have been more volatile than the other asset classes.

Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning $110,000 in 2010 dollars every year. This annual income is adjusted using the Consumer Price Index in order to obtain the corresponding income level for each year. Income is taxed at the appropriate federal income tax rate as it occurs. When realized, capital gains are calculated assuming the appropriate capital gains rates. The holding period for capital gains tax calculation is assumed to be five years for stocks, while government bonds are held until replaced in the index. No capital gains taxes on municipal bonds are assumed. No state income taxes are included.

Stocks in this example are represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Government bonds are represented by the 20-year U.S. government bond, and inflation by the Consumer Price Index. An investment cannot be made directly in an index.

U.S. Stocks and Bonds Before and After Taxes: 1926–2011



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Know Your Risks

Risk is the chance that you won't be able to meet your financial goals or that you'll have to recalibrate your goals because your investment comes up short. Investors face many forms of risk depending on the kinds of investments they choose.

Market, industry, and company risk: General market fluctuations can affect securities trading in that market. Stocks tend to fluctuate more than other asset classes, and may pose more risk over short periods of time. Investors looking to time the market run the risk of jumping into the market during the worst times, and out of the market during the best times. Security values can also decline from negative developments within an industry or company.

Credit and interest-rate risk: Credit risk is the possibility of a bond issuer not being able to make timely payments of principal and interest. The value of a bond may also decrease due to financial difficulties or the declining creditworthiness of the issuer. Interest -rate risk relates to how bonds tend to rise in value when interest rates fall, and to fall in value when interest rates rise. Typically, bonds with longer maturity exhibit greater price volatility.

Inflation risk: Inflation is a rise in the general level of prices for goods and services. If investments do not keep up with inflation, an investor's money will purchase less in the future than it did in the past.

Liquidity risk: Some investments may not be widely held by the public and may be difficult to sell if prices drop dramatically.

Currency risk: Returns achieved by local investors are often different from returns achieved by U.S. investors because of foreign exchange rates, even though both are investing in the same security.

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