Diversification: It is a word that investors constantly hear about. It is also an underlying theme to this month’s issue. In fact, we have three primary articles that discuss the topic in one manner or another.

The first article addresses the tax implications of diversification. Many of you have probably heard about incorporating an allocation to gold into your portfolios; however, few people can probably explain the IRS rules on holding gold in a retirement account. And it is not just gold that requires a special awareness. Master limited partnerships can cause unwanted headaches if distributions exceed $1,000 per year. Also, there are transactions that are prohibited.

To help you avoid such traps, I asked Bob Carlson to discuss the most common mistakes made by investors with their retirement accounts. Bob, who is the editor of Retirement Watch, responded with a very informative article that starts on page 7.

The second article highlights the mutual funds with the best five-year performance. In reviewing the data, one fact stood out: diversification worked.

For example, the 10 best-performing mutual fund categories represent a global mix of asset classes. A portfolio based on funds from these 10 categories would have generated an annualized five-year return of 7.8%. This would be considered a pretty good return during most years for a diversified portfolio. It is an exceptional performance when one considers that the S&P 500 sputtered over the past five years.

So what would a winning portfolio have looked like at the start of 2005? Assuming equal allocations to each mutual fund category, it would have contained: 30% international stocks (emerging markets, regional/country and foreign), 20% commodity stocks (gold and energy), 20% government bonds (intermediate and long-term), 10% emerging market bonds, 10% utilities and 10% corporate high-yield bonds.

There are a few caveats that I should note. First, a winning portfolio now will look different than it did five years ago. (This will especially be the case if yields begin to rise.) Secondly, the 7.8% return was calculated from category averages. Actual performance would have depended on the individual funds selected and whether any rebalancing occurred. It may have been better or worse.

Finally, the portfolio would have lost money in 2008, during the heart of the bear market. This should not be surprising given how difficult 2008 was. The only mutual fund categories to show gains for that period were related to government bonds or contra-market strategies. Nearly every other category posted a loss for the year. Nonetheless, the inclusion of bond funds did help to cushion the drop in the portfolio's value.

You can see which funds and categories delivered the best five-year performance in the article starting on page 13. The list opens by naming the funds with the highest five-year returns out of our entire database. Three are emerging market funds and two are mining funds.

The third article that I want to call your attention to is from Sam Stovall, the chief investment strategist for Standard & Poor’s. Sam looked at the performance of various asset categories during the recent bear market and compared it to other bear markets. He used his vast knowledge of market history to explain what was actually normal and why diversification did work. His analysis starts on page 25.

As Sam points out, diversification means incorporating different asset classes (stocks, bonds, commodities, etc.), not just different categories of stocks (e.g., large-cap, small-cap, emerging market). The benefit of doing this is confirmed by our analysis of mutual fund performance.

We are still looking at an uncertain future, but proper diversification can help you navigate your portfolio through it.

Wishing you prosperity,

Charles

Charles Rotblut
Editor, AAII Journal
twitter.com/charlesrotblut