

Private Wealth Management

Was it the Lost Decade of Investing?

How Proper Asset Allocation and Diversification Can Aid Long-Term Results

Much has been made about the Dow Jones Industrial Average (DJIA) breaking 10,000 earlier this month. However, this is not the first time this has happened. In fact, the DJIA first reached 10,000 on October 3, 1999, and eclipsed that mark again in 2003 and 2009. From point-to-point, the DJIA is almost breakeven over the past 10 years, prompting many to call this the 'Lost Decade' of investing. Nevertheless, with proper asset allocation and diversification investors could have profited without the need for fortuitous market timing or dramatic shifts in investment styles.

A Decade of Volatility

For purposes of this paper, we analyze the performance of the S&P 500 Index, which is considered a broader barometer of the U.S. equity market than the Dow Jones. From September 30, 1999 to September 30, 2009, the return of the S&P 500 is virtually flat at -0.15%. A flat-to-negative 10-year period is fairly rare; in fact, since 1926 it has occurred less than 5% of the nearly 900 monthly observations.

Despite the perception that the market was flat, the last 10 years were not short of interim volatility. This period encompassed the tail end of the tech bubble and the subsequent tech fallout, the housing bubble and the bursting of the housing bubble, a liquidity crisis in the financial markets, and finally the current strong market rally.

The Benefits of Asset Allocation...

A reasonable conclusion to the last decade's malaise would be that no gains have been made, but this is not the case. For those investors that were more broadly diversified and followed a disciplined asset allocation, positive returns could have been found. Asset allocation in its most basic form is the decision of how much to invest in stocks, bonds and cash. To illustrate the benefits of asset allocation, Table 1 below shows the performance of various stock/bond combinations. Over the past 10 years, adding an allocation to bonds would have improved return, lowered volatility (standard deviation) and increased the risk-reward trade off (Sharpe Ratio).

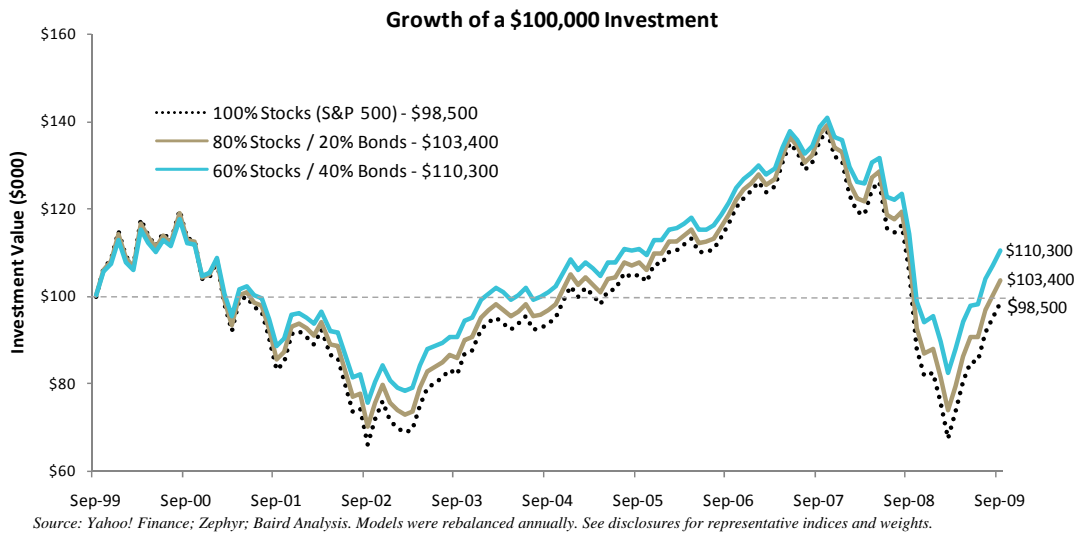
Table 1:

Sample Allocations	Performance as of 9/30/09 (annualized if greater than 1 year)						10-Year Statistics:	
	Year-to-Date	1-Year	3-Year	5-Year	7-Year	10-Year	Standard Deviation	Sharpe Ratio
100% Stocks (S&P 500 Index)	19.3%	-6.9%	-5.4%	1.0%	5.9%	-0.2%	16.2%	-0.19
80% Stocks / 20% Bonds	16.4%	-1.8%	-2.4%	2.3%	6.0%	1.5%	12.6%	-0.11
60% Stocks / 40% Bonds	13.5%	2.4%	0.2%	3.2%	5.9%	2.9%	9.3%	0.01

Source: Zephyr; Baird Analysis. Models were rebalanced annually. Represents a blend of the S&P 500 and BC Intermediate Govt/Credit indices.

Recall that the 10-year return of the S&P 500 is virtually flat, however; with the addition of bonds, the returns of the various blends are positive. An 80/20 stock-to-bond allocation returned 1.5% annualized and a 60/40 mix returned 2.9%. Compounded over a 10-year period that excess return can lead to real wealth creation. The chart on the top of page 3 shows the growth of an initial \$100,000 investment made 10 years ago. An investment in the 80/20 allocation grew to \$103,400 and the 60/40 allocation grew to \$110,300. Relative to the S&P 500's (negative) growth of \$98,500, that represents an incremental gain of \$4,900 and \$11,800, respectively.

2008 was among the most difficult market environments and was a harsh test of asset allocation. While it is true that most equity asset classes fell nearly in tandem, bond asset classes were down considerably less. The S&P 500 posted a 37% loss that year, compared to a loss of less than 30% had investors followed a 60/40 allocation. Other than cash investments, all asset classes faced hardships in 2008, but having a proper asset allocation would have helped to buffer some of those losses.



...and Diversification

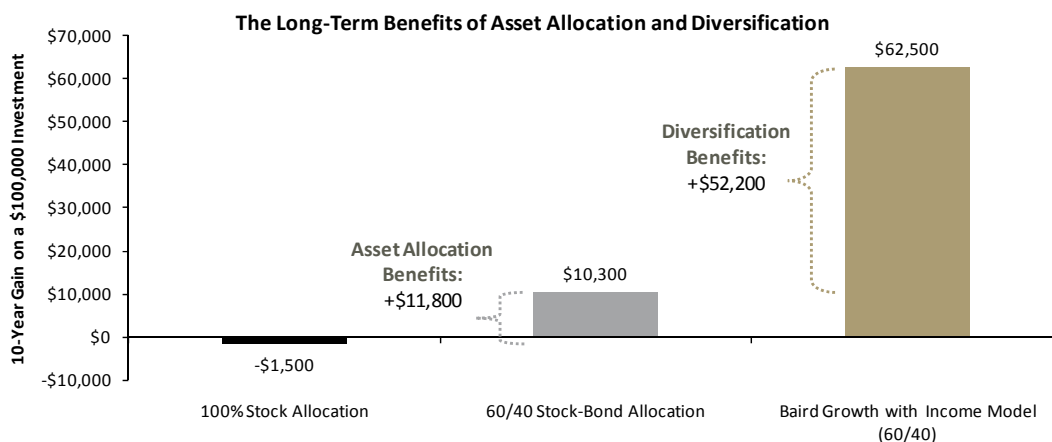
With the proliferation of investment options available to today’s investors, a simple stock/bond mix does not achieve the most efficient of portfolios. Baird’s Asset Allocation committee has designed several models that serve as a guide on how to properly diversify a portfolio. These models broaden the basic asset allocation decision to include U.S. and International stocks (diversified by style and market cap), satellite asset classes (high yield, emerging markets, commodities, real estate), fixed income, and cash. By properly diversifying even a stock-only portfolio (see All Growth Model below), better returns are obtainable and volatility is lessened. As an illustration, the Table 2 shows the investment results of Baird’s models, using market indices as proxies for the various asset classes. All three of Baird’s models listed in the table have bested the S&P 500 over all time frames and improved upon the basic stock/bond allocations. This is due to the combination of asset allocation and diversification.

Table 2:

Baird Asset Allocation Models	Performance as of 9/30/09 (annualized if greater than 1 year)						10-Year Statistics:	
	Year-to-Date	1-Year	3-Year	5-Year	7-Year	10-Year	Standard Deviation	Sharpe Ratio
All Growth Model (97% Stocks / 3% Bonds & Cash)	25.9%	-2.8%	-3.5%	4.1%	9.1%	3.6%	16.0%	0.04
Capital Growth Model (80% Stocks / 20% Bonds & Cash)	22.2%	1.1%	-1.0%	4.8%	8.7%	4.5%	12.9%	0.12
Growth with Income Model (60% Stocks / 40% Bonds & Cash)	17.5%	4.3%	1.3%	5.0%	7.8%	5.0%	9.4%	0.21
S&P 500 Index	19.3%	-6.9%	-5.4%	1.0%	5.9%	-0.2%	16.2%	-0.19

Source: Zephyr; Baird Analysis. Models were rebalanced annually. See disclosures for representative indices and weights.

Note, we have separated the concepts of asset allocation and diversification. It is first important to determine what mix of stocks, bonds and cash will help a client achieve their risk and return objectives. Then the asset allocation can be rounded out by gaining exposure to various segments of the overall market. The chart on the top of page 4 graphically depicts the gain/loss of that same \$100,000 investment over 10 years, illustrating what benefits can be had through asset allocation and diversification (+\$11,800 and +\$52,200, respectively).



Source: Zephyr; Baird Analysis. Models were rebalanced annually. See disclosures for representative indices and weights. Performance as of 9/30/09.

Investors Tend to Attempt Market Timing

Mutual fund flows into and out of various asset classes allow us to gauge how the average investor is reacting to the market environment. Table 3 below lists the annual net fund flows by broad category. Coming into the 2003 rally after the tech bubble burst, investors remained heavily invested in bonds and money market funds, missing a portion of the subsequent rally. More recently, in 2007 and 2008 when the economy became distressed, record amounts of assets were pumped into money market accounts, essentially locking in market losses. Since March 9, 2009, the market has rallied over 60%. It is our opinion that the average investor has not been fully participating in this rally. As these figures show, assets have come out of money market, but very little has made it into equity funds.

Investors' poor attempts at market timing have generally led to sub-optimal results over time. Maintaining a defined, yet flexible asset allocation plan can keep investors from the natural tendencies of overreacting to the current market environment.

Table 3:

Asset Classes	Annual Fund Flows (\$B)								
	Year-to-Date	2008	2007	2006	2005	2004	2003	2002	2001
U.S. Stocks	5	(151)	(48)	11	31	111	130	(25)	54
International Stocks	10	(82)	139	148	105	67	23	(3)	(22)
Taxable Bonds	175	19	98	45	26	3	39	124	76
Municipal Bonds	45	8	11	15	5	(14)	(7)	16	12
Money Market	(291)	637	654	245	63	(157)	(258)	(46)	375

Source: ICI; JPMorgan; Baird Analysis. Date as of 8/31/09.

Conclusion

Studies have shown that most of investment success is based on proper asset allocation and diversification, much more than investment selection or market timing. The asset allocation process is about maintaining a long-term perspective. This does not mean that a buy and hold strategy is the best fit, but it does mean that knee-jerk reactions to market events can impair long-term success. Working with a Financial Advisor can help identify your return objectives and tolerance for risk, which works to determine what asset allocation is most appropriate for you.

All investments or investment strategies involve risk. Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. This and other information is found in the prospectus. For a prospectus, contact your Baird Financial Advisor. Please read the prospectus carefully before investing.

Asset allocation does not guarantee protection against loss of principal. Past performance is not indicative of future results. Indices are unmanaged and an investment cannot be made directly in one.

Important Disclosures & Definitions

Sharpe Ratio: the Sharpe Ratio measures excess return per unit of risk. The Sharpe Ratio relates the difference between the portfolio's return and the return of the risk free rate to the standard deviation of the portfolio returns for the same period.

Standard Deviation: a gauge of risk that measures the spread of the difference of returns from their average. The more a portfolio's returns vary from its average, the higher the standard deviation.

S&P 500 Index (S&P 500): A representative sample of 500 leading companies in leading industries of the U.S. economy. This is considered a large-cap index.

Dow Jones Industrial Average (DJIA): The Dow Jones Average is a popular gauge of the stock market. It is based on the average closing prices of 30 industrial stocks. This is considered a large-cap index.

Russell 1000® Growth Index (R-1000G): Measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. This is a large-cap growth index.

Russell 1000® Value Index (R-1000V): Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. This is a large-cap value index.

Russell Midcap® Index (R-Midcap): Measures the performance of the 800 smallest companies of the Russell 1000 Index, which represent approximately 30% of the total market capitalization of the Russell 1000 Index. This is a mid-cap index.

Russell 2000® Index (R-2000): Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. This is a small-cap index.

Barclays (1-3) Yr Government/Credit Bond Index (BC 1-3GC): The Barclays 1-3 Year Government/Credit Index includes bonds covered by the Barclays Government/Credit Index, with maturities from 1 up to (but not including) 3 years. This is considered a short-term taxable bond index.

Barclays Capital Intermediate Government/Credit Bond Index (BCGCI): The BCGCI is composed of approximately 3,500 publicly issued corporate and U.S. government debt issues rated Baa or better, with at least one year to maturity. This is considered an intermediate taxable bond index.

Merrill Lynch US High Yield Master II Index (ML HY): The US High Yield Master II Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market. This is considered a high yield taxable bond index.

MSCI EAFE Gross (MSCI EAFE): A float-adjusted market capitalization index designed to measure developed market equity performance exc. the U.S. and Canada. This is considered an international index.

MSCI Emerging Markets (MSCI EM): The MSCI® Emerging Markets Index (Net) is designed to measure global emerging market equity performance. This is considered an emerging markets index.

Dow Jones Wilshire REIT (DJ REIT): Measures U.S. publicly traded Real Estate Investment Trusts (REIT's). This index is a subset of the Real Estate Securities Index. This is considered a real estate index.

All Growth Model: Assumes the following mix, rebalanced annually: 20% R-1000V, 16.75% R-1000G, 15.5% R-Midcap, 7.25% R-2000, 27.5% MSCI EAFE, 2.5% MSCI EM, 2.5% DJ REIT, 2.5% ML HY, 2.5% DJ UBS, 3% Cash.

Capital Growth Model: Assumes the following mix, rebalanced annually: 16.75% R-1000V, 14.25% R-1000G, 12.5% R-Midcap, 5.5% R-2000, 21% MSCI EAFE, 2.5% MSCI EM, 2.5% DJ REIT, 2.5% ML HY, 2.5% DJ UBS, 11.5% BCGCI, 5.5% BC 1-3GC, 3% Cash.

Growth with Income Model: Assumes the following mix, rebalanced annually: 14% R-1000V, 12% R-1000G, 8.5% R-Midcap, 3.5% R-2000, 14% MSCI EAFE, 2% MSCI EM, 2% DJ REIT, 2% ML HY, 2% DJ UBS, 25% BCGCI, 11% BC 1-3GC, 4% Cash.

80% Stock/20% Bond: Assumes the following mix, rebalanced annually: 80% S&P 500, 20% BCGCI.

60% Stock/40% Bond: Assumes the following mix, rebalanced annually: 60% S&P 500, 40% BCGCI.