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Diversification Kills

Toto, I've a feeling we're not in Kansas anymore – Dorothy

Some time ago I remember watching a fascinating documentary about deep sea divers. The narrator described the potential deadly effects of Nitrogen Narcosis, a condition wherein the nitrogen present in the diver's air tank is absorbed into the blood stream much more rapidly at depth causing symptoms similar to the effects of alcohol. Some divers suffering from this become so disoriented that they dive to even greater depths, and their deaths, not trusting that the bubbles they expel are pointing the way back up. I think I know how they must feel.

The past year has been one of the more frustrating ones that I can recall. The bubbles pointed one way and most folks went the other. Take, for example, the downgrading of the US credit rating by Standard and Poor's in August. On the heels of this anyone who passed a first year economics class would conclude that the price of US issued debt would have to fall, probably dramatically. Not only did this not happen, but US debt recorded one of its best performances in recent history with the 10 year treasury bond gaining almost 18% for the year. At the same time, US debt has climbed to 100% of Gross Domestic Product (GDP) excluding entitlements. When you add back the promises that we have made to ourselves in terms of Medicare, Medicaid and Social Security that are currently unfunded, the debt to GDP number approaches 500%. By way of comparison, Greece has a debt to GDP ratio of 142% according to the reporting agency Eurostat. Some in Washington believe that the way out is for our government to spend even more. Down is up.

I wasn't alone in missing the US government bond "opportunity". Bill Gross of PIMCO, arguably one of the best bond fund managers in the world, sold out of all US Government securities in the bond funds he manages early in the year only to buy them back later, after the rally, tail tucked firmly between his legs. Down is up.

The more diversified a portfolio was in 2011, the worse it performed. While the S&P 500 returned 0% (that's right, for all the gyrations this year the index finished unchanged) most US stocks performed much worse than this. Broader measures of the US and other stock markets reveal the following: The New York Stock Exchange Composite (which tracks the over 2000 stocks traded on that exchange) recorded a loss for the year of 6.1%. The Value Line Composite (stocks in this research company's database) lost 11.4%. Foreign stocks performed even worse with the Dow Jones Global Composite (excluding the US) recording a loss of 16.3% and the Dow Jones Asia Pacific Index losing 17.4% The Dow Jones Commodity Index lost 13.4% for the year. Having all of your eggs in the S&P 500 basket was the correct call in 2011. Down is up.

Investors bailed out of stocks and into bonds at a rapid clip in 2011. The current price earnings (p/e) ratio for the US stock market is 13.5 meaning that, on average, investors are willing to pay $13.50 for each $1 of earnings a company generates. Earnings are profits which can either be paid out in the form of dividends to shareholders, or ultimately may be reflected through an increase in the price of the stock. You can calculate a similar ratio for bonds by dividing the interest earned into the price of the bond. Using the current yield on the 10 year US Government Bond of 1.88% this ratio equals 53.19. Investors are willing to pay $53.19 for each $1 of interest earned. Granted, the risks of these two investments are not equal, but investors are willing to pay almost four times the price of the average stock to for the perceived safety of US government bonds. These folks are selling out of a relatively cheap asset to buy an extremely expensive one. Down is up.

When will this Narcosis wear off? I don't know, but I'm not about to turn away from the bubbles.