Definition and Past Research

Diversification is generally referred to as the only free lunch in investing. The concept dates back to the research of Harry Markowitz in the 1950s. His research identified that, by diversifying a portfolio among investments that have different patterns of return, investors can maximize their expected return for a given level of risk or minimize their risk for a given level of return. Markowitz received a share of the Nobel Prize for Economics in 1990 for his research and investors have been incorporating his teachings into practice for decades.

Several notable studies held from 1986 to 2003 measured the impact of asset allocation on the variations of portfolio returns. The original study by Brinson, Hood, and Beebower in 1986 focused on pension funds and compared their results to a policy portfolio constructed with market indices. It found that 93.6% of the variations in return were based on asset allocation. Market timing and security selection had a much more subtle impact on return variation. Three other major studies were conducted on this topic using either pension funds, mutual funds, or both (Brinson et al. (1991), Ibbotson and Kaplan (2000), and Vanguard (2003)). All of the studies confirmed that asset allocation was the largest determinant of return variability in a portfolio.

Practical Usage in Portfolio Management Today

We view allocating investment assets in a diversified manner as a part of our core philosophy in managing portfolios. In our research we analyze the effectiveness of a traditional portfolio made up of only global large cap stocks and long term bonds versus a diversified portfolio containing 12 asset classes across bonds, stocks, and alternatives. Below is a hypothetical example of how these two portfolios can be weighted for a 40% bond / 60% stock & alternative investor:

Using market indices to construct these two hypothetical portfolios and tracking their past returns and risk helps illustrate the impact of a diversified asset allocation. From January 1, 1967 through December 31, 2011, the traditional portfolio delivered a historical return of 8.5%/year with a historical volatility of 13.2%.
The diversified portfolio returned 9.6%/year with a historical volatility of 10.6%. The additional return for the diversified portfolio was a great benefit; however the reduced volatility was even more dramatic change. Take a look at the line chart below showing the growth of a $100,000 investment into each portfolio at the beginning of this time period, 1/1/1967. The $100,000 investment in the diversified portfolio grew to approx. $5.7MM versus only $3.6MM in the traditional portfolio.

**Diversification does not add Value All the Time**

The theory of diversifying a portfolio amongst many different asset classes is sound and the historical evidence based on market indices undisputedly backs up the theory. However, investors should be realistic about the potential outcomes. For example, this chart looks at our two hypothetical portfolios and the percentage of time that each outperformed over rolling 1-year, 3-year, and 10-year time periods.
In rolling 1-year time periods the diversified portfolios outperformed 58% of the time. When we extend the portfolio time horizons to three years and ten years, the percentages increase substantially to 67% and 78%, respectively. Since we invest based on probabilities, it is great to see the results continue to improve over longer time periods.

Return only tells half the story. The diversified portfolio almost always exhibited less risk than the traditional portfolio. The following chart shows how frequently the risk level of the diversified portfolio was less than the traditional portfolio over rolling 1-year, 3-year, and 10-year periods. This risk reduction helps allow for a greater compounding of wealth over time.

**THE INFORMATION PROVIDED BELOW IS NOT ACTUAL PERFORMANCE DATA AND IS BEING PROVIDED BY REGENT ATLANTIC FOR ILLUSTRATIVE PURPOSES ONLY**

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<th>Traditional Does Better</th>
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<td>Rolling 1-Yr Periods</td>
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*Source: Morningstar, for the time period 1967 to 2011*

The model portfolios shown are provided for illustrative purposes only. The portfolios are NOT intended to illustrate investment results that were actually achieved or could have been achieved by any of our clients. These portfolios are comprised of what we believe are the most appropriate available benchmark indices for the asset classes making up that portfolio and are shown less a 1% investment advisor management fee but do not account for typical fees and expenses incurred by our clients. Past performance is not indicative of future returns. For a complete description of the composition of each model portfolio, please see footnotes starting on P. 5.

**How Has Asset Allocation Changed?**

The theory and relevance of diversification is still holds strong today. However, there are elements of how we implement this strategy that will change over time. For example, the number of investable asset classes has grown significantly. This presents an ongoing need to review the relevance of the bond, stock and alternative asset classes one will use. Currently, we have four fixed income asset classes, five equity asset classes, and five alternative investment asset classes that we deem to be our opportunity set. There are also other asset classes that we researched extensively and for now deem to be unsuitable for portfolios.
Tactical Asset Allocation Changes

History has provided examples of different asset classes both out-performing and under-performing their long-term averages for extended periods of time. While timing shifts among asset classes is more art than science, we believe that the flexibility to make tactical adjustments to asset class weightings can provide opportunities to improve the risk/return profile of a given portfolio. There are two key factors to consider when evaluating the relative attractiveness of an asset class: valuations and market conditions. Valuations focus on the price we pay for any given investment, and tend to be formulaic. For example we can measure the price of a given stock asset class relative to the revenues, earnings, and book value. Analyzing market conditions is a more qualitative process. The conditions impacting any particular investment are likely to be best captured by a wide range of ever-changing factors. If implemented effectively, analysis of evolving market conditions can help to balance a valuation driven approach.

Conclusion

Shifting from theory to practice, we can see that diversification continues to be the only free lunch in investing even if it doesn't provide higher returns all the time. Over longer time periods, the evidence is clear that diversified portfolio have a high probability of better returns and less risk than a traditional portfolio. Our goal is to deliver superior implementation of a diversified asset allocation by continuously evaluating the opportunity set of available asset classes and tactically over weighting areas with the more favorable valuations and market conditions.

Important Disclosure Information

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by RegentAtlantic Capital, LLC (“RegentAtlantic”) will be profitable. Please remember to contact RegentAtlantic if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request. This article is not a substitute for personalized advice from RegentAtlantic. This information is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed in other businesses and activities of RegentAtlantic.

Descriptions of RegentAtlantic’s process and strategies are based on general practice and we may make exceptions in specific cases. A comparison to indices may not be a meaningful comparison. Comparisons to benchmarks have limitations because benchmarks have volatility and other material characteristics that may differ from the performance of a client’s portfolio. The investments in a client’s portfolio may differ substantially from the securities that comprise each index and are not intended to track the returns of any index. One cannot invest directly in an index, nor is any index representative of a client’s portfolio. Actual client accounts will hold different securities than the ones included in each index. The index returns are gross of applicable account transaction, custodial, and investment management fees. The actual investment results would be reduced by such fees and any other expenses incurred as an investor.

The allocations shown are the current allocations recommended by the Investment Committee. These allocations are subject to change based on the Investment Committee’s recommendations and are current as of May 1, 2012.

The allocation of the Traditional Portfolios 75% S&P 500 and 25% MSCI EAFE for Global Large Stocks and the BarCap Long US Corp Tr since 02/01/1990 and prior to that IS SBBI US LT Corp for Global Long Term Bonds. The charts shown compare the total return of a traditional portfolio as defined above and a Diversified Portfolio in the first chart.

The charts shown are intended to show the return and risk differences between the current allocation and a proposed allocation that RegentAtlantic would recommend. They are NOT intended to illustrate investment results that were actually achieved or could have been achieved by any of our clients. The reported return and risk (standard deviation) of each of the five sample portfolios was derived using what we, as of the date hereof, deemed to be the most appropriate available benchmark indices for the asset classes making up that portfolio. In addition, the returns used for each asset class are net of a 1% investment advisor management fee, but do not reflect any costs of investing such as commissions, and other expenses that investors would incur. For each portfolio, the relative portions invested in each of the asset classes specified for that portfolio were rebalanced to their target weights at the end of each year. Past performance is not indicative of future returns. Many factors affect performance including changes in market conditions and interest rates and in response to other economic, political, or financial developments.
The index or proxies used for each asset class are listed below. Where index data was not available, a proxy for that asset class was used or the asset class was not included as part of the portfolio mix until data was available.

**Asset Class: Short Term Corporate Bonds**

Primary Index: BarCap Corporate A+ 1-3 Years Total Return Index (Inception: 1/1/2003)

This U.S. Corporate Index covers USD-denominated, investment-grade, fixed-rate, taxable securities sold by industrial, utility and financial issuers and whose maturity period is at least ten years but not more than three years. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. It excludes bonds with equity–type features (e.g. warrants, convertibility to equity), private placements, floating rate issues and structured notes with embedded swaps.

Secondary Index: Merrill Lynch 1-Year Treasury Index (Inception: 1/1/1967)

The Merrill Lynch 1-Year US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue. The issue selected at each month-end rebalancing is the outstanding Treasury note that matures closest to, but not beyond, one year from the rebalancing date. To qualify for selection, an issue must have settled on or before the month-end rebalancing date.

You cannot invest directly in an index.

**Asset Class: Long Term Corporate Bonds**

Primary Index: BarCap Long US Corporate Total Return Index (Inception: 2/1/1990)

This U.S. Corporate Index covers USD-denominated, investment-grade, fixed-rate, taxable securities sold by industrial, utility and financial issuers and whose maturity period is at least ten years. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. It excludes bonds with equity–type features (e.g. warrants, convertibility to equity), private placements, floating rate issues and structured notes with embedded swaps.

Secondary Index: IA SBBI US Long Term Corporate (Inception: 1/1/1967)

Corporate Bond Total Returns are represented by the Citigroup Long-Term High-Grade Corporate Bond Index. The Index includes nearly all Aaa- and Aa-rated bonds with at least 10 years to maturity. If a bond is downgraded during a particular month, its return is included in the Index for that month before removing it from future portfolios.

**Asset Class: Opportunistic Bonds (Prior to 1/1/94 Opportunistic Bond allocations were added to Short-Term Corporate Bonds).**

Primary index: Credit Suisse/Tremont Hedge Fund Index Fixed Income Arbitrage (Inception: 1/1/1994)

The CS/Tremont Fixed Income Arbitrage Index is an asset weighted hedge fund index derived from the TASS database of more than 5,000 funds. The fixed income arbitrageur aims to profit from price anomalies between related interest rate securities. Most managers trade globally with a goal of generating steady returns with low volatility. This category includes interest rate swap arbitrage, US, and non-US government bond arbitrage, forward yield curve arbitrage, and mortgage backed securities arbitrage. The mortgage backed markets is primarily US based, over the counter, and particularly complex.

**Asset Class: International Bonds: (Prior to 2/1/1985 allocations to International Bonds were added to Short Term Corporate Bonds)**

Primary Index: JPM GBI Global Ex US Index (Inception: 4/1/1993)

JPMorgan GBI Global ex-US Index Hedged in USD is an unmanaged index market representative of the total return performance in U.S. dollars of major non-U.S. bond markets. It consists of regularly traded, fixed-rate, domestic government bonds of countries that offer opportunity to international investors. These countries have liquid government debt markets, which are stable, actively traded markets with sufficient scale, regular issuance and are freely accessible to foreign investors. The universe of bonds specifically excludes floating rate notes, perpetual, bonds with less than one year to maturity, bonds targeted at the domestic market for tax reasons, bonds with callable, puttable or convertible features.

Secondary Index: Citi WGBI NonUSD index (Inception: 2/1/1985)

The Citigroup Non-US Dollar World Govt Bond Index (formerly the Salomon Brothers World Government Bond Index (ex-U.S.)) is an unmanaged, market capitalization weighted index consisting of the government bond markets of the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Country eligibility is determined based on market capitalization and investability criteria. All issues have a remaining maturity of at least one year.

**Asset Class: Inflation Indexed Bonds (Prior to 4/1/1997 Allocations to Inflation Indexed Bonds were added to Short Term Corporate Bonds)**

Primary Index: BarCap US TIPS 10 YR+ Index (Inception: 7/1/2000) The index includes all publicly issued US treasury inflation protected securities that have at least 1 year remaining to maturity, are rated investment grade and have $250 million or more of outstanding face value. In addition, the securities must be denominated in US dollars, must be fixed rate and non-convertible and should have maturity period no less than 10 years. The index is market capitalization weighted and the securities in the index are updated on the last calendar day of each month.

Secondary Index: Citi US Inflation Linked Securities 5-10 YR Index (Inception: 4/1/1997)

The Citigroup U.S. Inflation-Linked Securities Index measures the return of bonds with fixed-rate coupon payments that adjust for inflation as measured by the Consumer Price Index (CPI). All issues have maturity of at least 5 years but less than 10 years.

**Asset Class: US Large Cap Stocks**

Primary Index: S&P 500 Index (Inception: 1/1/1967)

**Asset Class: International Large Cap Stocks (Prior to 1/1/1970 allocations to International Large Cap Stocks were added to US Large Cap Stocks)**

Primary Index: MSCI EAFE (Inception: 1/1/1970)
The S&P 500 is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe. Each constituent in an index is weighted by its market-capitalization, as determined by multiplying its price by the number of shares outstanding after float adjustment. The price return of an index is a measure of the cap-weighted price movement of each constituent within the index.

Asset Class: International Large Cap Stocks (Prior to 1/1/1970 allocations to International Large Cap Stocks were added to US Large Cap Stocks) *

Primary Index: MSCI EAFE (Inception: 1/1/1970)

The S&P 500 is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe. Each constituent in an index is weighted by its market-capitalization, as determined by multiplying its price by the number of shares outstanding after float adjustment. The price return of an index is a measure of the cap-weighted price movement of each constituent within the index.

* The term “Global Large Cap Stocks” represents a blend of 85% US Large Cap Stocks and 15% International Large Cap Stocks.

Asset Class: US Small Cap Stocks

Primary Index: Russell Microcap Index (Inception: 1/1/2000)

The Russell Microcap Index measures the performance of the microcap segment of the U.S. equity market. It makes up less than 3% of the U.S. equity market. It includes 1000 of the smallest securities in the small-cap Russell 2000® Index based on a combination of their market cap and current index membership and it includes the next 1,000 securities. The Russell Microcap Index is constructed to provide a comprehensive and unbiased barometer for the microcap segment trading on national exchanges, while excluding lesser-regulated OTC bulletin board securities and pink-sheet stocks due to their failure to meet national exchange listing requirements. The Russell Microcap Index is reconstituted annually to ensure larger stocks do not distort performance and characteristics of the true microcap opportunity sets do not distort performance and characteristics of the true microcap opportunity set.


Currently, the Small Company Stock return series is the total return achieved by the Dimensional Fund Advisors (DFA) Small Company 9/10 (for ninth and tenth deciles) Fund. The Fund invests in a broadly diversified cross section of small companies. DFA's portfolio construction includes stock selection that is based on market capitalization and eligibility criteria. DFA's proprietary database includes more than 9,000 securities. Data is analyzed from a variety of sources that include industry publications, research reports as well as a number of electronic data services. The U.S. 9-10 Small Company Strategy target universe includes those companies that have a market capitalization in the lowest 4 percent of the market universe. The market universe is defined as the aggregate of the NYSE, AMEX and NASDAQ NMS firms. Asset Class: International Small Cap Stocks

Asset Class: International Small Stocks

Primary Index: MSCI EAFE Small Cap Index (Inception: 1/1/1993)

The MSCI EAFE Small Cap Index Fund targets 40% of the eligible small cap universe in each industry group of each country represented by the MSCI EAFE Index. MSCI defines the small cap universe as all listed securities that have a market capitalization in the range of $200 - $1,500 million USD. In addition to this capitalization range, MSCI uses a specialized framework of foreign inclusion factors to adjust the market capitalization of securities for free float available to foreign investors.


The International Small Company Portfolio is a no-load mutual fund designed to achieve long-term capital appreciation. The Portfolio pursues its objective by investing in the small companies of Canada (0-15%), Europe (25-50%), Japan (15-40%), Pacific Rim (0-25%), and the United Kingdom (15-35%). The Portfolio currently invests in companies in Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.


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Asset Class: Emerging Markets Stocks (Prior to 1/1/1970 allocations to Emerging Markets Stocks were added to International Small-Cap)

Primary Index: MSCI Emerging Markets Index (Inception: 1/1/1998)

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets and which aims to capture 85% of the (publicly available) total market capitalization.


The Emerging Markets Portfolio is a no-load mutual fund designed to achieve long-term capital appreciation. The Portfolio pursues its objective by investing in emerging markets equity securities that Dimensional deems to be large company stocks at the time of purchase. Dimensional will consider, among other things, information disseminated by the International Finance Corporation in determining and approving countries that have emerging markets. The Portfolio currently invests in companies in Brazil, Chile, China, the Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, South Africa, South Korea, Taiwan, Thailand, and Turkey. Due to repatriation restrictions, the Portfolio currently holds but does not purchase securities in Argentina.

Asset Class: Frontier Markets Stocks (Prior to 6/1/2002 allocations to Frontier Markets Stocks were added to Emerging Markets Stocks)
Primary Index: MSCI Frontier Markets Index (Inception: 6/1/2002)

MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of the following 25 frontier market country indices: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Qatar, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, United Arab Emirates, and Vietnam. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index. The MSCI Bosnia Herzegovina Index, the MSCI Botswana Index, the MSCI Ghana Index, the MSCI Jamaica Index, MSCI Trinidad & Tobago and the MSCI Zimbabwe Index are currently stand-alone country indices and are not included in the MSCI Frontier Markets Index. The addition of these country indices to the MSCI Frontier Markets Index is under consideration.

Asset Class: Hedging Strategies (Prior to 6/1/1998 allocations to Hedging Strategies were added to Global Large Cap Stocks)

Primary Index: Dow Jones Credit Suisse Blue Chip Hedge Fund Index (Inception: 8/1/2003)
The Dow Jones Credit Suisse Blue Chip Hedge Fund Index is an asset-weighted, investable index of hedge funds. The index provides a rules-based and fully investable index, enabling investors to participate in the performance of a diversified market barometer for the hedge fund industry.

The Long Short Credit Index is made up of funds in our database that meet the MSCI Long-Short classification. These Long-Short Credit funds take exposure to credit-sensitive securities, long and short. Trades are based around credit analysis of the issuer and security, and may incorporate credit market views, and may be based either on anticipated price movement or positive carry. The manager assumes credit risk either long or short as a core part of the investment strategy, but interest rate risk is not a significant exposure, being either explicitly hedged or simply far less significant than credit risk.

Asset Class: Infrastructure (Prior to 2/1/1996 allocations to Infrastructure were added to Global Large Cap Stocks)

Primary Index: Alerian MLP index (Inception: 2/1/1996)
The Alerian MLP Index (“Index”) is a market-cap weighted, float-adjusted index created to provide a comprehensive benchmark for investors to track the performance of the energy MLP sector. It is a composite of the 50 most prominent energy master limited partnerships calculated by Standard & Poor’s using a float-adjusted market capitalization methodology. The Index components are selected by Alerian Capital Management, LLC. Alerian is a registered investment advisor that exclusively manages portfolios focused on midstream energy MLPs. The index is disseminated by the New York Stock Exchange real-time on a price return basis (NYSE: AMZ).

Asset Class: Real Estate (Prior to 1/1/1972 allocations to Real Estate were added to Global Large Cap Stocks)

Primary Index: FTSE NAREIT All REITs Index (Inception: 1/1/1972)

FTSE NAREIT All REITs Index represents the full universe of publically traded REITs, including those companies that do not meet minimum size rule, liquidity criteria or free float adjustments. Stocks are free-float weighted to ensure that only the investable opportunity set is included within the index.

Asset Class: Commodities (Prior to 1/1/1980 Allocations to Commodities were added to Global Large Cap Stocks)

Primary Index: Dow Jones UBS Commodity Index (Inception: 1/1/1991)
The Dow Jones-UBS Commodity IndexSM (DJ-UBSCISM) is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The DJ-UBSCISM is composed of futures contracts on physical commodities. The index is designed to minimize concentration in any one commodity or sector. It currently includes 19 commodity futures in five groups. No one commodity can comprise less than 2% or more than 15% of the index, and no group can represent more than 33% of the index (as of the annual reweighting of the components).