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N.M.'s Investment Funds Wisely Diversified

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A recent letter to the Journal's Monday Business Outlook questioned the logic of diversification for New Mexico's investment funds. The letter correctly pointed out that had the funds invested solely in S&P 500 stocks for the 2011 fiscal year that the funds would have made better returns and that stocks historically outperform bonds in the long run. Thus, for a long term fund, why should one diversify rather than just buying stocks?

How much of a loss in the shorter term can one stomach to wait for the promised superior return? What magnitude of loss constitutes a catastrophic, enterprise ending loss? How can one protect against a catastrophic loss? These are all questions an investor must ask one's self. The answers usually lead to some desire for risk control. Risk control is the primary reason for diversification. This is a well established principle of modern portfolio theory as well as fiduciary law. By combining assets with various sensitivities to economic factors, it is possible to create a portfolio with a return not much less than just stocks (or in some time periods greater) with far less variability of return and thus lower potential for loss. While stocks have historically provided superior returns, they have done so at high levels of risk. Returns have varied considerably from one year to the next, including large losses in some recent years. For instance although the S&P 500 returned 30.7% in fiscal year 2011 (July 1,2010-June 30, 2011), the S&P lost 26.2% just two years ago in fiscal year 2009. During that period, ERB's portfolio was down 17.3%. The smaller loss does illustrate the benefits of diversification.

Also, while stocks have produced superior historical returns in the long run, sometime the long run has been a very long time. For instance the chart below lists the average annual return that ERB has earned (after fees and expenses) versus the S&P for various time periods ending June 30, 2011. Note that for all but the longest time periods, the diversified portfolio did as well or better than the S&P:

	5 Year	10 Year	15 Year	20 Year	25 Year
ERB	4.9%	5.2%	6.6%	8.4%	8.5%
S&P	2.9%	2.7%	6.5%	8.7%	9.4%

It should be noted that the S&P return is not reduced by any fees. However, there is some expense incurred for an investment in an index fund and actual realized returns would be somewhat less. Thus, even the 20-year return would be closer to a break even than the chart shows.

Further, these are historical returns. What does each mutual fund disclaimer tell the investor? Something like this: "Past performance is no guarantee of future results. Investing carries some degree of risk..etc". In other words, stocks have historically provided superior returns over long (again, sometimes very long) periods, but they may not do so in the future. We, as investors, invest in an environment of uncertainty; we can recount with absolute precision what happened in the past, but lack any certainty of how the future may unfold.

Another compelling reason for diversification is a legal one. Diversification is a firmly established principle in fiduciary law in the management of New Mexico funds, as well as the standard for institutional funds nationwide. ERB's investment activities are governed by the Uniform Prudent Investor Act, a part of New Mexico's Statutes. It specifically addresses diversification as follows: 45-7-604. Diversification.

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

All of New Mexico's large investment funds are diversified. This diversification has paid off in the past and we expect it to do so in the future. It would be very difficult to craft the legal argument in favor of not diversifying the investments. The purpose of the ERB's investment trust (payment of retirement benefits) is best served with well diversified investments. Thus, we maintain a portfolio that is diversified not only between various categories of stocks and bonds but also among other asset classes and strategies including private equity, real estate, natural resources, opportunistic credit, absolute return strategies and global tactical asset allocation.