Modern Portfolio Theory for Dummies

When you combine different assets in a portfolio, you get the average returns from the different assets, but your risks (the variability of these returns) tend to cancel each other out, since one asset is likely to be up when another is down.

Implications for Investors:

- The Total Portfolio Rules
- Individual Stockpicking = Yesterday's News
- Extreme Diversification

Our goal is to develop well-tempered portfolios to weather a variety of investment climates. Unless you are extremely diversified, you are taking too much risk for the returns you are getting.

People are often told that if they want higher returns from investing, they should increase the proportion of stocks in their portfolio, or invest in "aggressive growth" stocks (whatever they are).

This is like telling people to drive 100 miles per hour if they want to get somewhere sooner. While it's possible that they will arrive faster, it also dramatically increases the liklihood that they won't arrive at all.

In investing, gains and losses are not symmetrical.

Question: If the NASDAQ fell 75% from its March 12, 2000 peak, what percent does it have to climb to get back to where it was?

Answer: 300%.

This is why Warren Buffett says the first rule of investing is not to lose money, and the second rule is to remember the first rule.

While there are no guarantees (even the DFA "normal balanced" portfolio lost money in 1973, 1974 and 2002), adequate diversification can save you from a multitude of problems: you lose less, and you recover faster.

Dynamic Asset Allocation

At Conservative Wealth Management, our target asset allocation is not static. We overweight those asset classes that are undervalued relative both to their long-term fundamentals as well as to each other, while underweighting those that are pricier.