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The “Skittles” Chart & the Importance of Asset-Class Diversification

Alan Werba, CPA, CFP®
Managing Member

Aaron Rubin, JD, CPA, CFP®
Sr. Wealth Manager

3055 Olin Ave., Suite 2000
San Jose, CA 95128

408 260-3138

Given all the attention the media devotes to this hot stock or that hot sector, you may ask yourself, “Why does Werba Rubin Wealth Management believe so passionately in their asset-class approach?”

The “Skittles” chart shown below paints a colorful picture of the relative performance of the most commonly used asset classes over the last fifteen years. Within the chart also lies the answer as to why we believe asset-class diversification works.

The Skittles chart reports the total annual returns

of various market indices, with returns ordered from the highest performing asset class to the lowest.

For instance, in 1996 the index associated with Real Estate Investment Trusts (REITs) was up 35.3% making it the best performer for that year. The worst performing index for that year was Five-Year Government Bonds, with a positive return of 2.1%. Two years later in 1998, REITs were the worst performing asset class with a loss of 17.5%, while Five-Year Government Bonds showed a positive return of 10.2%, the 5th best performer.

Asset Class Performance	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Annualized Returns
	REITs	Small Value	Large Growth	Emerging Markets	REITs	Small Value	5 Year Gov't	Small Value	REITs	Emerging Markets	REITs	Emerging Markets	5 Year Gov't	Emerging Markets	Small Value	Small Value
35.27%	36.94%	36.65%	65.82%	26.37%	40.59%	12.95%	74.48%	31.58%	29.32%	35.06%	36.87%	13.11%	84.74%	34.59%	12.10%	
S&P 500 Index	Large Value	S&P 500 Index	Small Growth	5 Year Gov't	REITs	REITs	Emerging Markets	Emerging Markets	EAFE	Emerging Markets	Large Growth	Inflation (CPI)	Small Value	Small Growth	REITs	
22.96%	33.75%	28.58%	54.06%	12.60%	13.93%	3.82%	70.66%	28.00%	13.54%	31.84%	15.70%	0.09%	70.19%	31.83%	10.54%	
Small Value	S&P 500 Index	EAFE	Large Growth	Inflation (CPI)	5 Year Gov't	Inflation (CPI)	Small Growth	Small Value	REITs	EAFE	EAFE	S&P 500 Index	Large Growth	REITs	Emerging Markets	
22.36%	33.36%	20.00%	30.16%	3.38%	7.61%	2.39%	54.72%	27.33%	12.16%	26.34%	11.17%	-37.00%	38.09%	27.96%	10.15%	
Large Growth	Large Growth	Large Value	EAFE	Small Value	Inflation (CPI)	Emerging Markets	EAFE	EAFE	Large Value	Large Value	5 Year Gov't	REITs	Small Growth	Large Value	S&P 500 Index	
21.27%	31.67%	11.95%	26.96%	-3.08%	1.55%	-9.68%	38.59%	20.25%	9.70%	21.87%	10.05%	-37.73%	38.09%	20.17%	6.77%	
Large Value	REITs	5 Year Gov't	S&P 500 Index	Large Value	Large Value	Small Value	REITs	Large Value	Small Growth	Small Value	S&P 500 Index	S&P 500 Index	Large Value	Large Value	5 Year Gov't	
19.97%	20.26%	10.22%	21.04%	-6.41%	-2.71%	-11.72%	37.13%	17.74%	6.02%	21.70%	5.49%	-39.12%	37.51%	17.64%	5.82%	
Small Growth	Small Growth	Small Value	Large Value	S&P 500 Index	Emerging Markets	EAFE	Large Value	Small Growth	S&P 500 Index	S&P 500 Index	Small Growth	EAFE	EAFE	Emerging Markets	Large Growth	
13.22%	14.88%	4.08%	6.99%	-9.10%	-3.65%	-15.94%	36.43%	11.16%	4.91%	15.80%	4.99%	-43.38%	31.78%	17.34%	5.80%	
Emerging Markets	5 Year Gov't	Inflation (CPI)	Small Value	EAFE	Small Growth	Large Growth	S&P 500 Index	S&P 500 Index	Small Value	Small Growth	Inflation (CPI)	Small Growth	REITs	S&P 500 Index	Small Growth	
10.83%	8.38%	1.60%	4.37%	-14.17%	-4.13%	-21.93%	28.69%	10.88%	4.46%	9.26%	4.09%	-43.41%	27.99%	15.06%	5.16%	
EAFE	EAFE	Emerging Markets	Inflation (CPI)	Large Growth	S&P 500 Index	S&P 500 Index	Large Growth	Large Growth	Inflation (CPI)	Large Growth	Large Value	Small Value	S&P 500 Index	EAFE	EAFE	
6.05%	1.78%	-3.32%	2.68%	-14.33%	-11.89%	-22.10%	17.77%	5.27%	3.42%	5.97%	-12.24%	-44.50%	26.46%	7.75%	4.70%	
Inflation (CPI)	Inflation (CPI)	Small Value	5 Year Gov't	Small Growth	Large Growth	Large Value	5 Year Gov't	Inflation (CPI)	Large Growth	5 Year Gov't	REITs	Emerging Markets	Inflation (CPI)	5 Year Gov't	Large Value	
3.33%	1.70%	-10.04%	-1.76%	-24.50%	-21.05%	-30.28%	2.40%	3.25%	3.39%	3.15%	-15.69%	-52.67%	2.72%	7.12%	3.92%	
5 Year Gov't	Emerging Markets	REITs	REITs	Emerging Markets	EAFE	Small Growth	Inflation (CPI)	5 Year Gov't	5 Year Gov't	Inflation (CPI)	Small Value	Large Value	5 Year Gov't	Inflation (CPI)	Inflation (CPI)	
2.09%	-24.26%	-17.50%	-4.62%	-30.40%	-21.44%	-34.63%	1.88%	2.26%	1.35%	2.55%	-18.38%	-53.14%	-2.40%	1.50%	2.40%	

Data Sources: Center for Research in Security Prices (CRSP), BARRA Inc. and Morgan Stanley Capital International, January 2011 All investments involve risk. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Past performance is not indicative of future performance. Treasury bills are guaranteed as to repayment of principal and interest by the U.S. government. This information does not constitute a solicitation for sale of any securities. CRSP ranks all NYSE companies by market capitalization and divides them into 10 equally-populated portfolios. AMEX and NASDAQ National Market stocks are then placed into deciles according to their respective capitalizations, determined by the NYSE breakpoints. CRSP Portfolios 1-5 represent large-cap stocks; Portfolios 6-10 represent small caps; Value is represented by companies with a book-to-market ratio in the top 30% of all companies. Growth is represented by companies with a book-to-market ratio in the bottom 30% of all companies. S&P 500 Index is the Standard & Poor's 500 Index. The S&P 500 Index measures the performance of large-capitalization U.S. stocks. The S&P 500 is an unmanaged market value-weighted index of 500 stocks that are traded on the NYSE, AMEX and NASDAQ. The weightings make each company's influence on the index performance directly proportional to that company's market value. The MSCI EAFE Index (Morgan Stanley Capital International Europe, Australasia, Far East Index) is comprised of over 1,000 companies representing the stock markets of Europe, Australia, New Zealand and the Far East, and is an unmanaged index. EAFE represents non-U.S. large stocks. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes and different methods of accounting and financial reporting. Consumer Price Index (CPI) is a measure of inflation. REITs, represented by the NAREIT Equity REIT Index, is an unmanaged market cap-weighted index comprised of 151 equity REITs. Emerging Markets index represents securities in countries with developing economies and provide potentially high returns. Many Latin American, Eastern European and Asian countries are considered emerging markets. Indexes are unmanaged baskets of securities without the fees and expenses associated with mutual funds and other investments. Investors cannot directly invest in an index.

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The most striking thing about this chart is the lack of any pattern or consistency. Asset class returns vary widely from year to year. And the top performer one year is often the bottom performer the next year — and vice versa. Another term for this variance of returns is “Low Correlation.” Low correlation between asset classes held in a portfolio is considered to be the cornerstone of effective diversification that helps lower portfolio volatility. This concept is the foundation of Modern Portfolio Theory.

Let’s examine the chart historically. The mid to late 1990s are remembered, particularly in Silicon Valley, as the high tech boom years. During this period, the two top performing asset classes were Large Growth Stocks and the S&P 500 Index. Large Growth was in the top four asset classes from 1996 through 1999 while the S&P 500 Index was no lower than 5th place. Inflation remained low while Bonds, Emerging Markets and International Stocks trailed the US stock markets.

From March 2000 through April 2003, the tech bubble burst, dropping the returns for Large Growth and the S&P 500 down the chart. From 2000 through 2006 Large Growth remained in the bottom four slots while the S&P stayed in the bottom five asset classes. REITs had strong performance during this period, appearing consistently in the top five. Do you remember the mad dash to buy rental properties, build spec houses and acquire vacant land? Of course, we now realize that much of the real estate boom of this period was fueled by lax banking restrictions. Real estate became the next asset class to burst a bubble in 2007 and 2008 as the bottom dropped for most types of real estate.

The great crash of 2008 was a humbling experience for investor and advisor alike. As for the biggest loser, U.S. Large Value stocks led the way with Emerging Markets not far behind. The S&P did the best of the equity categories losing only 37%! The only safe hiding place was Five-Year Government Bonds, which had their best year in 15 years. However, investors who stayed in bonds through the end of 2009 watched their investment fall by 2.4%, while the equity asset classes rose between 26.5% and an eye-opening 84.7%. While equity investors were severely punished in 2008, they were handsomely rewarded in 2009 and 2010. We now know that those who stayed in the market after

the October 2008 crash fared far better than those who moved to cash or other fixed income positions after the crash.

From a strategic perspective, an important lesson was once again brought home. Timing the market clearly is a roll of the dice, and one of the only ways to try to capture the good years is to maintain a well-diversified model portfolio that is rebalanced as time goes on. By rebalancing in the good years, positions with disproportionate gains can be sold at a relatively high point. Asset classes that have underperformed are purchased with the proceeds, so that the investor buys some relatively low-priced shares.

This year’s “dog” can be next year’s outstanding performer or it can be a dog for a second year. The Five-Year Government Bonds asset class was in the bottom five of asset classes nine times, and in the top five six times. It only had two years of negative returns in fifteen years, but only 11% + returns for four years. U.S. Large Value and Small Value both had ten years in the top five. Over a fifteen year period, U.S. Large Value was only the sixth best performer while U.S. Small Value was the best.

We can also observe the importance of being true to *Structured Investing* and Modern Portfolio Theory. Looking at the results, value outpaced growth by about 4.3%. Small outperformed large by about 3.3%. The U.S. only outperformed international by .09%. Five-Year Government Bonds returned an average of 6.5%. Thus even through one of the worst decades in history, those tilted towards value with healthy representation of small, and diversified internationally could look back on the past fifteen years with few regrets.

The Skittles chart clearly shows the importance of asset class diversification. It also demonstrates the need for a strategic plan to guide you through the emotional highs and lows of the markets. Investors need bonds to dampen market turbulence. Investors should also consider tilting their portfolios toward small stocks and value stocks to improve expected returns while lowering overall volatility. And most importantly, investors need to stick to their investment “blueprint” to increase the odds for achieving their long-term goals.

If you have any questions about the Skittles chart or investing please contact us at (408) 260-3138.

¹Value category includes Small Value and Large Value; Growth category includes Large Growth and Small Growth.

²Small category includes Small Value and Small growth; Large category includes S&P 500, Large Growth, Large Value and EAFE.

³U.S. category includes Small Value, Small Growth, Large Value, Large Growth, and S&P 500; International category includes Emerging Markets and EAFE.