

The Diversified Portfolio Index TM

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Achieving an investment rate of return, that is merely average but very consistent, may result in exceptional performance, even if for a lucky few. Over longer and longer durations, it becomes increasingly difficult to outperform.

After 40 years of working in Wall Street, absorbing all the data and information I could consume on the subject of investing, I found that it did not provide me with the knowledge required to be a successful long-term investor. The anticipated wisdom from the acquisition of all this knowledge and data remained elusive. In time, the en vogue investment styles and asset classes eventually succumb to mediocrity, or worse, total collapse. Although they post some successful trades, investors ultimately face a few bad trades, resulting in very mediocre overall performance. Even picking a series of securities that work well, an active trader would continue to make trades until reaching the point where having done nothing would have been better. Even hindsight could not provide me with a particular style that would have provided better than average performance for a standard portfolio. While equities were favored for the long run up to 2000, an investor would yearn to have been in bonds during the poor stock performance since 2000. The problem of where to be or how to invest going forward, had remained a mystery to me the longer I was in the investment business.

Then, I accidentally came up with something smart. Past performance and hindsight revealed the investment strategy on how to have had a simple asset allocation methodology for an investment portfolio, which can be used effectively by the common individual investor going forward. The answer was the Diversified Portfolio Index™ (DPI™). The science to this strategy is to own everything - all asset classes for a standard diversified portfolio. The average growth rate of the totally diversified portfolio, containing all the investment asset classes, has the potential to provide a rate of return that I originally suspected would outperform a less diversified portfolio, most of the time. After analyzing historical data, it became clear that there is enormous value to the methodology. While history does not indicate what may happen in the future, I noticed that the average growth rate of the standard diversified portfolio produced returns that exceeded most less diversified portfolios, all of the time. The total calculation is the sum of all portfolio returns, from the best to the worst. The average annual performance appeared to be over the 50% percentile (arithmetic mean is higher than the median), thus outperforming most of the individual investments in each year. If this portfolio can

consistently match the average rate of return year after year, exceptional performance can be realized. This cumulative long-term result generates superior relative performance, doing better each year, versus competitors, as time goes on.

If it is to be believed that the investment markets are efficient and that no one can “beat the markets” in the long run, then one should simply own all the markets, all five asset classes: *U.S. STOCKS, INTERNATIONAL STOCKS, BONDS, REAL ESTATE, PRECIOUS METALS AND COMMODITIES*. If all markets are represented by a haystack and you are always trying to find the needles in that haystack to own in a portfolio, then you should “buy the haystack” in order to own all the needles. [One thing to realize though is that investing in general has its risks and each of these asset classes has their own unique set of risks. It's best that you work with an advisor to ascertain which, if not all of these asset classes, can work for you in your unique circumstances.] This is accomplished by first defining an encompassing diversified asset class, which represents all investment markets in a standard diversified portfolio allocation, and then securitizing this diversified class. This has been accomplished with the creation of the DPI™. This, I believe, is the first “portfolio index” model that has been created to represent investing in general. The specifics are detailed in the *Methodology Guide for the Diversified Portfolio Index™*. The asset allocation is summarized here.

Asset Allocation of the Diversified Portfolio Index™	
U.S. Stocks	40%
International Stocks (ex-U.S., weighted by GDP)	10%
Bonds (all maturities)	30%
U.S. Real Estate	10%
Precious Metals	5%
Commodities	5%

This hypothetical example of an asset allocation mix is for illustrative purposes only and does not reflect upon any specific

investment. Your specific allocation may vary based on your specific circumstances. It is not possible to invest in this or any market weighted index.

The merits of this diversified methodology are validated by timeless truths. For example, it is said that performance is better accomplished with "time in the markets and not timing the markets." Investing is like a Chinese finger trap: the more you move the worse off you are. Investing is a marathon, not a sprint. The odds of successful investing are encumbered by the odds against the investor with a surfeit of variables to overcome. The investor has to find the right investment advisor that has to pick the right asset classes and then select the right securities of each of those asset classes. There just are so many options from which to choose. Some investors may choose to use stocks, bonds, or cash equivalent investments. Please understand though, past performance of any of these strategies do not assure any guarantee that it will be replicated by future performance.

Even if the investor selects a strategy that works for them, eventually the question becomes, do you change the strategy, thinking that it is now prudent to do so? Too many of us end up zigging when we should have zagged. The technology available to individual investors also provides a misplaced feeling of increased confidence, rarely justified. The odds of investing successfully are simply reduced with the increase of disciplines or variables one has to contend with. Bull markets increase performance thus causing confusion between luck and skill in portfolio management. Human nature can be our worst enemy with respect to successful portfolio management. There is a tendency to become attached to a position and not sell it while it is trading at a peak, only to see it fall in price. Then, fear sets in and one might finally sell it at a substantially reduced price, only to see it go up again. These are constant factors to contend with in investment management.

The DPI™'s best use is as a tool to weigh the relative performance of any investment portfolio. Managers of pension funds and large institutional funds understand well the merits of diversification in all asset classes and can execute these well-diversified methodologies. Their tremendous funding allows for purchasing of securities in the full spectrum of asset classes. The investment manager then assesses relative performance to a chosen index according to the particular style of investing being implemented.

However, the investor is looking at an investment portfolio and desires to have a metric to compare his or her own portfolio to either other possible portfolios or to actual portfolios of other investors. "How is my portfolio doing?" is the obvious question. It is a simple, straight-forward question. Unfortunately, the answer has never been simple or straight-forward. That is, until now. Using the DPI™ as a comparative "portfolio benchmark" creates an effective reference to answer exactly this question for both the institutional manager and the individual investor.

While asset allocation has the potential to create most of a portfolio's investment performance results, the DPI™ study of past performance shows further that with a minimum of adjustments, better performance can be achieved. It shows that subjective strategies rarely add value to achieving performance. The net effect of active management can be measured when comparing actual results to the DPI™. It would allow even the largest institutional investments a simple method of measuring the value of their management by checking their positive or negative deviation from the DPI™. They could also easily view what the markets would have provided in that timeframe using a standard diversified portfolio.

The back study results were calculated using Thomson Investment View 2010 which has 23,342 funds with which to do comparative performance studies. This data represents real results of the universe of strategies employed, active and passive, traditional and creative. There are outliers in each individual year, but true excellence is revealed by which pulls ahead over the long run. These numbers were calculated on a best effort basis and are unaudited.

PERIOD	YRS	DPI™ RETURN	FUND RANKING OF 23,342	PERCENTILE RANKING
2010	1	13.23%	9,884	57.7%
2008-2010	3	2.80%	5,131	78.0%
1996-2010	5	6.05%	2,469	89.4%
2001-2010	10	5.58%	3,140	86.5%
1996-2010	15	6.69%	1,963	91.5%
1991-2010	20	8.11%	1,300	94.4%

Comparing the results in cumulative periods yields these percentile ranking results.

CUMULATIVE PERIODS FROM 1990-2010						INDIVIDUAL PERIOD RETURN	FUND RANKING OF 23,342	PERCENTILE RANKING
1y	3y	5y	10y	15y	20y			
<input checked="" type="checkbox"/>						13.23%	9,884	57.7%
<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>					2.80%	1,721	92.6%
<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>				6.05%	998	95.7%
<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>			5.58%	550	97.6%
<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>		6.69%	222	99.0%
<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	8.11%	92	99.6%

It is possible that in future behavior the various asset classes may not show the same historical distributions of relative performance of the separate asset classes. This accounts for the concern that perhaps the advantage was due to the fact that the last twenty years saw an ideal stock market in the first ten years of the study followed by another ten years of an optimum bond market. Of course, this also implies that the reverse is true. This means that DPI™ performance was high during a decade of poor bond market performance followed by another decade of poor stock market performance. In my opinion, it is not the performance, per se, as much as the consistency of performance that produces a true advantage.

It is not only the average of the annual returns that matter. Strategies may vary from each other year to year but still have the same average annual return. Intuitively, the end result should be that they both produce the same total return, but this is not actually true. The investment with the higher volatility, meaning a greater range of

individual annual returns, will produce a lower total return over the same period than an investment with lower volatility. This is crucial to real success in investment management.

The DPI™ methodology of a fixed allocation across all markets is designed to achieve better performance when compared to other known strategies. Note that annual rebalancing keeps the asset allocation within tolerance, while seeking to minimize performance drag induced by trade activity.

I believe that individual investors would be well-served to become familiar with the DPI™. It is a basis to formulate a personal portfolio methodology and compare the results to the investable universe to see if the strategy is adding value. The investor gains a better understanding of portfolio asset management. Comparison to the DPI™ determines whether it is just transient luck that has allowed you to catch a seasonal trend.

You must also choose your entry point and exit point. Countering this issue remains difficult to accomplish. For example, if from March 1997 to March 2002 one remained fully invested in most of the stocks from the S&P 500, one would have tracked a 10% rate of return. However, if the best ten days of the market were missed, there is almost a 90% loss of return, leaving only 1.07%. This shows again that it is time in the market, not timing the market, which adds value.

The timeless wisdom of investing is encompassed in the Diversified Portfolio Index™ Benchmark. We are aware of the Efficient Market Hypothesis by Eugene Fama, the asset allocation study by Harry Markowitz and William Sharpe, *A Random Walk On Wall Street* by Burton Malkiel and more recently the writings of Nassim Nicholas Taleb in his books *The Black Swan* and *Fooled by Randomness*. All of these works value the theme of diversification.

Diversification can add a stabilizing effect to portfolio performance, where the value of consistency of performance is more important over time than trying to seek superior returns by speculating which asset class will outperform another over shorter periods of time. Instead of trying to find the needles in the haystack, one can use the uniqueness of the DPI™ methodology to capture the entire haystack. Own all the markets, all of the time. By doing so, you increase the total returns over time.

However, remember that no strategy, including asset allocation and diversified portfolio, does not ensure profit or guarantee against loss or market risk. There is no guarantee that these strategies will enhance overall returns or outperform a less finely allocated or diversified portfolio.

Investing in mutual funds are subject to the risks of their underlying investment holdings including possible loss of principle. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

Generally, among asset classes, stocks may present more short-term risk and volatility than bonds or short-term instruments. Bonds generally present less short-term risk and volatility than stocks, but bonds contain interest rate risk issuer default risk and inflation risk.

Foreign investments, especially those in emerging markets, involve greater risk and may offer greater potential return than U.S. investments.

The fast price swings of commodities and precious metal investments will result in significant volatility in investors' holdings. They are highly speculative investments and therefore should not represent any significant portion of a clients' portfolio.

Investing in real estate/REITS involves special risks such as potential illiquidity and property devaluation based on adverse economic and real estate market conditions, and may not be suitable for all investors. There is no assurance that the investment objectives of the program will be attained.

Using an analogy of the investment tree to represent the investment choices, an investor can choose from to formulate a portfolio; one can look at the growth rate of individual leaves to represent securities and branches representing segments of asset classes. The trunk represents the culmination of all possible investment choices, which is best represented by the DPI™. In time, which leaves or branches of investing survive the test of time and will grow the most is capricious and always in doubt. The trunk on the other hand will almost always be steadily growing. That growth rate encompasses the average growth rates of all the leaves and branches offered by the choices of the investment tree.

For the common investor, human nature must be overcome in order to potentially increase performance results. While attempting to succeed in the investment arena, natural behavior can be an investor's worst attribute. There is a pervasive feeling that once you buy a security, it goes down and once you sell it, it then goes up. The DPI™ eliminates the human folly of trying to time the markets and the insidious human tendency of buying on hot trends and selling low when all looks gloomy. There is the old adage that "nothing looks better than a market about to go down or looks worse than when the markets are about to go up." The markets mimic that it is often darkest before dawn. I believe that investors would be well served to avoid letting this routinely affect investing behavior. On the other hand, the annual rebalancing mechanism to objectively reset the asset allocation to the DPI™ standard helps the index to stay the course.

The probability that humans will err with their investment decisions over a lifetime of investing outweighs their judgment on how to actively invest successfully. Therefore, performance is better served with passive asset allocation and a simple rebalancing system. It is, after all, from the investor's perspective that it is "performance, performance, performance and that all else are excuses." The academics are correct, the market is efficient yet random [Burton Malkiel and Harry Markowitz], and much more is attributable to luck than we care to admit [Nassim Nicholas Taleb]. Accomplishing an average yearly return each year in your investment portfolio is indeed a very difficult and rare accomplishment.

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