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Super Diversifiers

Adding commodities to your portfolio without all the stomach-churning

BY STANLEY W. ANGRIST • As last week's shakiness on Wall Street showed, it's nice to hedge your bets by having some investments that zig when the stock market zags. Of course, many investors believe they already are doing this when, for example, they divide their investable assets into three parts: stocks, bonds and cash. But such conventional allocations represent "dinosaur diversification," maintains Robert Gavrich, an investment adviser in San Francisco. "It may have sufficed 20 years ago, but today, when there are several other strategic asset classes available to individual investors, it falls far short. Today, you'd be putting two-thirds of your money into chronic underperformers [cash and bonds], and the other third in some of the world's most expensive stocks."

In recent years, in the search to trim long-term volatility and produce good results, some investors have focused on small-cap stocks, international equities and real-estate investment trusts to diversify. The theory is that these often move in a direction opposite to the S&P 500 and the bond market.

But there's another possibility that might prove quite rewarding: Using small-caps, foreign stocks and REITs in conjunction with the **Oppenheimer Real Asset** Fund, to create a group of "super diversifiers" that generally can help a portfolio churn out juicy returns while trimming its riskiness.

The fund, available since March, allows an investor to play the commodities markets without the stomach-churning that would be occasioned by holding futures contracts for 25,000 bushels of soybeans or 75,000 pounds of orange juice.

Oppenheimer Real Asset tracks the Goldman Sachs Commodity Index, making only incidental use of futures and options. Thus, it's directly tied to the cost of materials that go into many products, and can limit the damage that inflation wreaks on financial assets like stocks and bonds.

THE MAGIC OF SUPER DIVERSIFICATION

► Over the long haul, an investor would have done better with a portfolio that included REITs, small-cap stocks, foreign equities and commodities than one that held only cash, bonds and S&P 500 stocks.

	MR. CONSERVATIVE		MRS. MODERATE		MS. HIGH FLYER	
	Super Diversified Portfolio	Conventional Asset Allocation	Super Diversified Portfolio	Conventional Asset Allocation	Super Diversified Portfolio	Conventional Asset Allocation
Stocks	10%	33%	20%	50%	20%	33%
Bonds	10	33	10	50	0	0
Cash	30	33	0	0	0	0
Small-Cap	10	0	20	0	20	33
Intl Stock	10	0	20	0	20	33
REITs	10	0	10	0	20	0
Real Assets	20	0	20	0	20	0
ANNUAL PERFORMANCE (for selected years)						
1973	9.36%	−2.95%	1.23%	−7.89%	−0.21%	−20.16%
1974	1.64	−4.71	−7.72	−11.06	−10.29	−23.19
1977	9.41	−0.91	11.50	−3.93	13.81	12.09
1987	7.82	2.67	8.23	1.27	8.14	6.85
1990	2.42	3.61	−4.74	1.51	−6.89	−16.06
1994	3.01	−0.78	3.08	−3.13	4.18	4.14
1996	16.47	9.15	19.58	11.13	23.19	15.58
TWENTY-SIX YEAR PERFORMANCE (1971-1997, through September)						
Rate of Return	12.87%	10.55%	15.43%	12.02%	15.90%	15.45%
Risk	0.0589	0.0810	0.1026	0.1216	0.1104	0.1646
RECENT BULL MARKET PERFORMANCE (1991-1997, through September)						
Rate of Return	11.92%	12.53%	14.93%	15.75%	15.51%	15.61%
Risk	0.0574	0.0828	0.0802	0.1209	0.0801	0.1000

The following were used to obtain performance numbers: Stocks: Total return of the S&P 500. Small stocks: Dimentional Fund Advisors 9/10 Small Company Fund. International stocks: Morgan Stanley Europe Australasia Far East Index. Bonds: Total return of 20-year Treasury bonds. REITs: National Association of Real Estate Investment Trusts All Equity Index. Real Assets: Goldman Sachs Commodity Index. Cash: 30-day Treasury bills. The standard deviation of annual returns was used as a proxy for risk.

Source: Ibbotson Associates

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The fund buys commodity-linked assets such as notes, tied either to a commodity index like Goldman's or to the price of a specific commodity, such as oil. It negotiates private contracts with either commodity producers, such as Cargill, or financial intermediaries, such as banks and investment banks.

Russell Read, the fund's portfolio manager, doesn't recommend it as a standalone investment. "What's important is that it goes up at a different part of the business cycle than stocks and bonds," he observes. Indeed, while the S&P and Dow were falling Monday by 6.87% and 7.18%, respectively, the fund actually rose by about 1%.

More important, consider what happened when the stock market declined in 1973 and 1974. The S&P index dropped 38% but the GSCI rose 144%. That would have reduced an investor's suffering a lot. When the bond market went dead from 1977 through 1980, dropping 6.8%, the Goldman Sachs Commodity Index tacked on 115%.

The index, which has been calculated back to 1971, is based on futures prices for 22 commodities in rough proportion to their importance in the world's economy. Currently, for example, the index is heavily weighted toward energy, with about 55% of its value coming from products related to that sector.

While some other funds hold a large number of energy-related securities, Real Asset is unusual in owning assets whose price is directly tied to physical commodities.

Since investors frequently use October 1987 – during which the last market crash occurred – as a benchmark of what happens when big trouble hits, it's worth noting that, while the S&P plunged 21.5% that month, the Goldman Sachs Commodity Index rose by a little over 1%.

When an investor adds the super diversifiers to a portfolio, the long-term returns rise a little, says Gavrich, and risk drops a lot, whether the investor's risk-tolerance is low, moderate or high.

Assume that Mr. Conservative Investor, as shown in the table, has a portfolio divided equally among cash, stocks and bonds that would have earned an annual compound rate of return of 10.5% over the past 25¾ years. By using a super-diversified portfolio of 50% small stocks, international stocks, REITs and real assets and putting the other 50% in S&P 500 stocks, bonds and cash, the return to the portfolio would have increased by 2.3% annually. And risk, as measured by the standard deviation of annual returns, would have dropped by 27%.

Mrs. Moderate Investor, whose results are also shown in the table, has simply allocated half her portfolio to stocks and half to bonds. Her compound annual return over the past 25¾ years would have been 12.0%. But allocating 70% of her holdings to the new diversifiers would have increased her annual compound return to 15.4% and decreased her risk by 15%.

As for Ms. High Flyer, who's willing to buy risky stocks in the hope of hitting a grand slam, her portfolio, divided equally among U.S., international and small-cap shares, has achieved a robust annual return of 15.5%. However, by reducing the allocation to each of these three groups by 20% and investing it in REITs and real assets, the return rises by 45 basis points and the risk drops by more than 32%.

The table also shows how Mr. Conservative, Mrs. Moderate and Ms. High Flyer would have fared in the bull market that started in 1991. Annual returns would have nearly matched those of conventional portfolios, but in every case, risk would have dropped by at least 19%.

Crucial to this strategy, Gavrich says, is periodic rebalancing of the portfolio back to its original percentage allocations, which trims the outperformers and accumulates the laggards. He recommends that investors with taxable accounts rebalance annually or every 18 months to minimize Uncle Sam's bite. Investors with tax-deferred accounts can rebalance as often as convenient.

From time to time, some of the items in the model portfolios actually may move in sync, to the investor's detriment, as the market for small-caps has been hammered recently along with larger stocks. However, over the long haul, the benefits of super diversification are undeniable. ■

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