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Benefits of Diversification

"Don't put all your eggs in one basket" is a common expression that most people have heard in their lifetime. It means don't risk losing everything by putting all your hard work or money into any one place.

To practice this in the context of investing means diversification—the strategy of holding more than one type of investment, such as stocks, bonds, or cash, in a portfolio to reduce the risk. In addition, an investor can diversify among their stock holdings by buying a combination of large, small, or international stocks, and among their bond holdings by buying short-term and long-term bonds, government bonds, or high- and low-quality bonds.

A diversification strategy reduces risk because stocks, bonds, and cash generally do not react identically in changing economic or market conditions. Diversification does not eliminate the risk of experiencing investment losses; however, by investing in a mix of these investments, investors may be able to insulate their portfolios from major downswings in any one investment.

Over the long run, it is common for a more risky investment (such as stocks) to outperform a less risky diversified portfolio of stocks, bonds, and cash. However, one of the main advantages of diversification is reducing risk, not necessarily increasing return. The benefits of diversification become more apparent over a shorter time period, such as the 2007–2009 banking and credit crisis. Investors who had portfolios composed only of stocks suffered large losses, while those who had bonds or cash in their portfolios experienced less severe fluctuations in value.

James E. Salter
Chief Operating Officer
george@blossomwm.com
(925) 833-9999

Monthly Quote

"I like the dreams of the future better than the history of the past."

- Thomas Jefferson

The Labyrinth of Financial Statements: The Cash-Flow Statement

The Labyrinth of Financial Statements: The Cash-Flow Statement Public companies in the United States are required by law to disclose relevant business figures and other information. They do this in the form of financial statements: documents whose purpose is to offer detailed information on the company's financial situation: what the company owns (assets), what it borrowed and therefore has to pay back (liabilities), its stock, profit, cash going in and out, and other figures. All financial statements must follow official accounting rules and must be publicly available. There are three major financial statements: the balance sheet, the income statement, and the cash-flow statement. This article will focus on the cash-flow statement.

The cash-flow statement shows cash going in and out of the firm during a period of time. Based on activity type, it is organized into three sections: cash flow from operating activities, investing activities, and financing activities.

1. Cash flow from operating activities This section lists the sources and uses of cash that result from normal, day-to-day operations of the firm. The operating activities portion always starts with net income (the profit the company has made). Usually, there are four items that need to be added to or subtracted from net income in order to arrive at operating cash flow: depreciation, the change in accounts receivable, the change in accounts payable, and the change in inventories. The result is net cash flow from operations.

Depreciation represents the decrease in the value of physical resources resulting from wear and tear over time. For example, a piece of equipment is originally purchased for $50,000, but after being used for a year, its value decreases to $40,000. The $10,000 difference is depreciation. Accounts receivable designates the money the company is waiting to receive as payment for products sold or services rendered. Let's say the company sells a product for $5,000 on Oct. 3, but it does not expect payment until the end of the month. That $5,000 will go under accounts receivable until the actual payment is made. Accounts payable is just the opposite—the company has already received a product or service, but will not pay for it until later. Inventories represent the raw materials, work in progress and finished products the company has in stock at a certain point in time. Changes in all these items affect operational cash flow.

2. Cash flow from investing activities A company, just like an individual, can invest its money in order to increase the value of its assets. For example, if a construction company purchases new construction equipment, this will probably be considered an investment in property, plant, and equipment (PP&E), and the cash outflow will show up under investing activities on the cash-flow statement. A company can also invest in the equity of other firms, subsidiaries, joint ventures, acquisitions, and others.

3. Cash flow from financing activities This section indicates how the company is raising capital to finance its operations. Cash inflow can be created by stock or bond issues, and cash outflow by debt payment or the repurchase of shares. Also, if the company pays a dividend to its stockholders, this will have to be recorded here (dividend payment is usually a significant financing cash outflow).

The sum (positive or negative) of cash flows from operating, investing, and financing activities represents the net increase (or decrease) in the firm's cash during a certain period of time (normally a year). Of the three numbers, the most important one is cash flow from operations; ideally, this would be the company's largest cash inflow. The cash flow statement is essential in determining a company's situation because it focuses on what's happening to the firm's cash. Even if net income looks great on the income statement, a company's position may be very weak if it doesn't have enough cash coming in.

Destination Correlation

"Correlation" and "correlated assets" are mainstay expressions in the jargon of investors and financial professionals, and while the concept of correlation can be confusing to novice investors, a quick explanation can clarify why correlation is a key factor in portfolio construction.

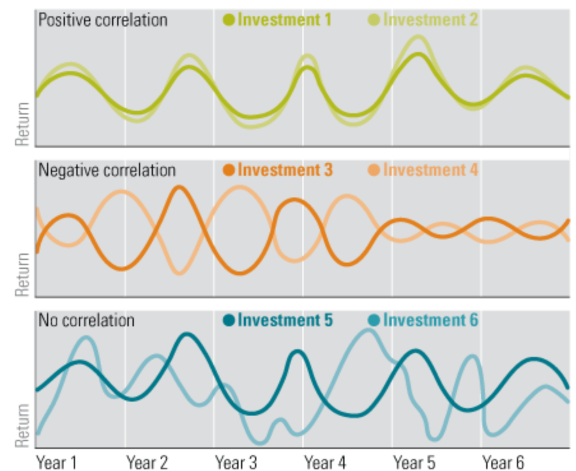
Let's say you or your financial advisor are trying to choose two investments in the construction of a portfolio. Would you prefer investments that are similar (move in the same direction) or investments that are dissimilar? Think about it this way: If you are going on vacation to an unknown island, what type of clothes will you put in your suitcase? If you only take summer clothes and the island nights turn out to be cold, or if you only bring winter clothes and the climate is tropical, your vacation will probably end in tears. It's the same with investing: You're better off diversifying than putting all your money in similar investments.

In order to create a truly diversified portfolio, the investments in the portfolio have to compensate for each other's shortcomings. If investment A declines in value, ideally you would want investment B to increase in value, or at least decline less than investment A. In order to achieve this, you need two investments that behave differently, meaning they have a low correlation.

Correlation is a statistical measure designed to quantify the interrelationship of two investments (again, investment A and investment B). By taking into account the characteristics of the two investments, a mathematical formula calculates a number between –1.00 and +1.00. This number is called the correlation coefficient. If this coefficient is negative (for example, –0.81), we say the two asset classes are negatively correlated. This simply means they tend to move in different directions: if asset class A declines in value, asset class B is likely to increase in value, and vice versa. If the correlation coefficient is positive (for example, +0.34), the two asset classes tend to move in the same direction: they are positively correlated. A correlation coefficient of zero means the asset classes are completely uncorrelated; their movements in relation to one another are random.

Adding investments with low correlation to a portfolio can soften the impact of market swings because the investments do not all react to economic and market conditions in the same manner. For example, building a portfolio with large, small and international stocks would probably not be such a good idea because stocks are generally highly correlated to one another—if large stocks go down, the other stock categories will probably go down, too. The same logic applies to a portfolio with only bonds. However, combining stocks and bonds in a portfolio could provide a significant diversification benefit because these two types of investments do not tend to move together (they have a low correlation).

Various Levels of Correlation



Past performance is no guarantee of future results. Diversification does not eliminate the risk of investment losses. Investment returns shown and correlation numbers mentioned in the text are based on hypothetical data. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds.

Simple Steps for Late Savers

The sooner you start putting aside money for retirement, the more you might have once that highly anticipated day arrives. Saving for college tuition, purchasing a new home, unforeseen medical expenses, or life's other necessities, surprises, or even enjoyments can cause investors to postpone saving. Starting the retirement planning process late in one's life can be daunting, but it is by no means impossible.

Crunch the Numbers: The first step to getting back on track is to put together a budget—this will force you to focus on your financial situation and can serve as a roadmap to success. Once you have outlined all of your expenses, simply subtract the total from your net income. The result will give you a clear indication of how much you can potentially save, and also help you identify areas in which you may be spending too much.

Cut Any Unnecessary Expenses: There are essential expenses that cannot be eliminated: food, electricity, etc. However, most people can identify some areas, like entertainment, that are not vital to one's existence and can be cut back on. The more areas that you can trim will lead to more money that can be earmarked for retirement.

Take Advantage of Catch-up Contributions: Catch-up contribution limits allow investors age 50 and above to increase their contribution. For example, they can make an extra contribution of $5,500 to their 401(k) in 2011, equating to a maximum contribution of $22,000. IRA catch-ups are $1,000 in 2011, leading to a maximum contribution of $6,000.

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James E. Salter
Chief Operating Officer

Blossom Wealth Management
PO Box 125
Alamo, California 94507

george@blossomwm.com

Tel:(925) 833-9999
Fax:(877) 665-8765