*the*Plan

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Home Bias by Nathan J. Twining, CFP®

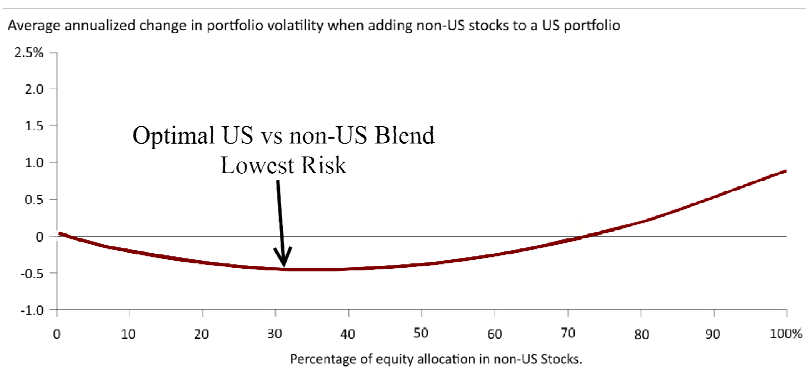
If you've been with us long enough, you know that we value efficient diversification on a very large scale. True diversification decreases your risk without decreasing your expected return over long periods of time; an invaluable component of a robust financial plan.

Not only do we invest in thousands of different securities, but we also invest across the globe. But how and why do we choose to do so? Traditionally, investment managers would match how much they invest in each country with how large that country's investment "footprint" was, making investments proportional to the market capitalization of each country. Another strategy has been to attempt to predict which countries will do well or poorly and invest accordingly. We know the latter doesn't work, so is the former the ideal approach?

Not for us. We prefer a more pragmatic approach and the result is an intentional "home-bias." We invest more heavily in the US than in non-US securities. Why?

Non-US markets are not perfectly correlated to US markets and they provide access to industries and companies that you otherwise would not be investing in. All of these factors provide a significant diversification benefit. However, investing in foreign marketplaces is more costly than investing in domestic markets and bears additional risks. Typically, there are larger bid-ask spreads, more market impact from trading, higher management fees, political risks, and currency fluctuations that all serve to negatively influence risk and return. The goal therefore is to maximize the diversification benefits at minimal cost.

Figure 1



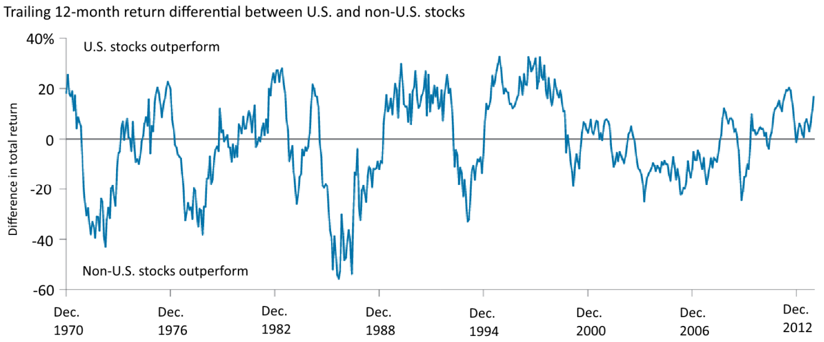
Notes: US equities represented by MSCI USA Index; non-US equities represented by MSCI World Index ex-USA from 1970 through 1987 and MSCI All Country World Index ex-USA thereafter.
Sources: Vanguard, Thomson Reuters Datastream, and MSCI.

Figure 1, above right, shows the percentage of equity allocated to non-US Stocks compared to the change in volatility (as measured by standard deviation). Essentially, this shows what percentage of stocks historically needed to be allocated to non-US markets to achieve the maximum diversification benefit, based on historical data.

As with any backwards looking analysis we must recognize that the past does not predict the future. Models of past data span several generations and may not be indicative of the optimal mix moving forward, especially when one considers that each portfolio is constructed with different constraints. What we can see, however, is that you can achieve optimal diversification without taking on unnecessary risks or costs. Historically, an investor would only need around 30% of their stocks in non-US markets to gain maximum benefit; much less than the actual market weight of non-US markets. Keep in mind, however, that you still want a healthy exposure to non-US markets to fully capture the benefits.

Figure 2 shows the non-correlated nature of US and non-US stocks. Recently, non-US markets have performed poorly causing many less-disciplined investors to discredit their benefit. We often hear that "the markets" are doing great and then our portfolio is only doing "okay." The reason is because "the markets" usually only refers to a small portion of the US equity market, either the S&P 500 or the DOW. Only investors who concentrated solely in the S&P 500 or DOW would have returns close to the commonly cited "market;" not an advisable position for long term investors who understand pragmatic investing. I fully expect a well-diversified equity portfolio to outperform the S&P 500 over my investing lifetime, despite periods of underperformance.

Figure 2



Notes: U.S. equities represented by MSCI USA Index; international equities represented by MSCI World Index ex USA from 1970 through1987 and MSCI All Country World Index ex USA thereafter. Data through December 31, 2013.
Sources: Vanguard, Thomson Reuters Datastream, and MSCI

In the past several years, I've been able to review portfolios from other investment management firms. There are two common trends; they either avoid non-US Markets, or they match market capitalization. Neither of these strategies is ideal and indicate either a lack of proper diversification, discipline, or direction.

At Financial Plan, we understand that costs and risk matter. We want to gain the maximum diversification benefit in the most efficient manner possible. We can rely on academics and pragmatic investing to achieve it. The benefit to our clients is an overall reduction in costs and risks in a practical manner, which *does* correlate to higher expected future returns.

on a Personal note

Jamie & Jeanne

Wow, things just got really tough in the Twining household last Sunday. Something happened that had me walking around in a depressed fog for days. We put my son Matt on suicide watch. So, what was it that hit us so hard? Was it a death in the family?

No, it was ***far*** worse… the Seahawks were one yard away from winning the Super Bowl, and instead of running with their #1 running offense in the league, they passed! ARRGGHHH!!!! The interception resulted in the most shocking and depressing (for us) finish to any Super Bowl.

Oh well, it was a great season, and there is always next year. As we keep telling ourselves, it ***is*** just a game, right?

So now we forget about games and get back to living our real lives, with all of the joys and sorrows that go along with that; so much more important than football!

Jeanne and I wish all of you a fulfilling year, surrounded by friends and family.

Devin & Stephie

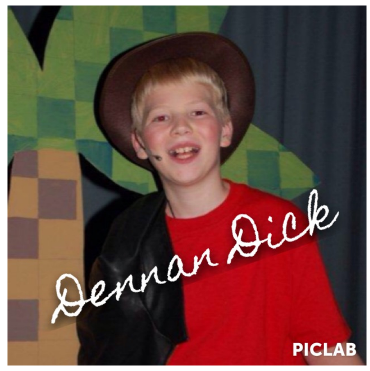
I just read Nate's personal note and I must say I'm jealous. This time of year always seems to be busy between work and volunteer activities. This year St. Paul's Academy joined up with the Assumption wrestling team, so I am the coach of two middle school wrestling teams. Although the team is all first year wrestlers it is very rewarding to watch the young men get better every week!

I'm teaching three classes at Whatcom Community College 1. Charitable Giving 2. Social Security Claiming and 3. Financial Planning / Strategies. These classes are always more work than I anticipate, but sharing my knowledge and passion for finance always feels good.

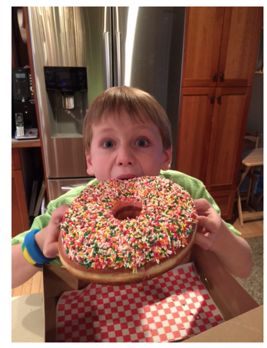
We just completed the finishing touches on our "investment property," but apparently we did too good of a job since we have decided to move in March 1st! If things weren't busy enough adding a move puts us over the top. Our next investment property is approved by the City and I have been working on getting bids, financing, and contracts pulled together. I promise we won't move in this time:)

With everything going on the family is still doing great. Supermom (Steph) deserves a lot of credit for keeping the household together. Last weekend Graedon helped me slow down and enjoy the present. I walked while Gray rode his bike 2 miles to get hot chocolate. Gray takes his time, so this was a three hour adventure. Being able to slow down and not worry about what needed to be done for that 3 hours was amazing. Thanks Gray for reminding me to smell the roses, relax, and enjoy the present.

Dave & Bonnie



This fall our middle son Dennan was the lead in his 6th grade musical. What an accomplishment. He played Isaiah Jones, a take off on Indiana Jones and did such a great job!



James also had a milestone...he hit double digits on Dec. 30th. He enjoyed the biggest & best doughnut cake EVER!

Kristin just picked out her Freshmen courses for next year… HOW CAN IT BE that we have a high-schooler? Where is the time going?

Nate and Lisa

I'm amazed that it's already been a year since Annalise was born. On one hand, it seems like she's still brand new but on the other I can't recall what life was like before her. The same was true of Finley. What did I do with all my time before I had children!?

Of course, last year I was also saturated with CFP material, studying and prepping for the exam. So with a newborn and a 3-year old in the mix, it's no wonder my life has seemed like a blur recently.

Now that things are slowly starting to calm down, what am I doing with myself? Well, I'm reading "for pleasure." I put that in quotes because my pleasure reading doesn't look much different than the CFP study material. It's not all investment books however; I re-read Watership Down and finally read CS Lewis's Space Trilogy. I also started the Game of Thrones as I'm somewhat of a Fantasy nerd and it's recent popularity sparked my interest.

I have this bad habit of starting series that haven't yet ended, as I did with *The Gunslinger* (King), *The Wheel of Time* (Jordan) and now *A Song of Fire and Ice* (Martin). I'm trying to read slowly enough so that the final two books are actually written by the time I get there. Otherwise it's back to the study material for me!