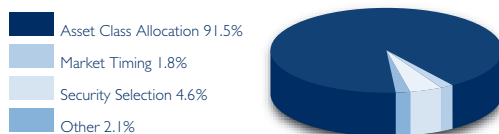


## MODERN PORTFOLIO THEORY

Modern Portfolio Theory (MPT) is a preferred investment strategy of some of the world's largest endowments, pension funds and foundations. Its founders, led by University of Chicago economist Harry Markowitz, won the Nobel Prize in Economics in 1990. In 1992, the American Institute of Law incorporated the principles of MPT in their revised definition of the Prudent Investor and in 1994, the Uniform Law Commissioners drafted the Uniform Prudent Investor Act, which states that trustees who use MPT are acting in the most prudent manner possible on behalf of beneficiaries.

MPT begins with the premise that it's less risky to invest in several asset classes than to place all of one's wealth in one asset class. It builds on that basic principle of diversification to a level that increases the likely return while decreasing overall risk. MPT considers more than just asset-class diversification. It also considers the number of asset classes to be used, the percentage of the total portfolio in each asset class and the correlation among them. This potentially allows for both lower risk and superior returns.

### IMPORTANCE OF ASSET ALLOCATION



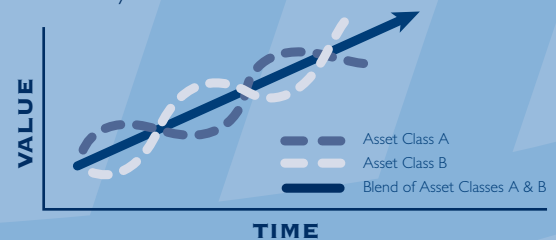
Studies have shown that the single most important factor in determining a portfolio's return isn't security selection or market timing—it's the number and weight of specific asset classes. MPT separates your holdings into specifically allocated and weighted asset classes, then goes beyond that by considering the correlation among classes. This process is intended to produce a portfolio that gives you the best return with the least risk. Source: *Financial Analysis Journal*, B.G.P. Brinson, B.D. Singer and G.L. Beebower—June 1991



## ASSET-CLASS CORRELATIONS— THE KEY TO MPT

We select investments to generate the highest returns consistent with the specific risk level you choose. By analyzing and using asset-class correlations, MPT allows the choice of decreasing risk while maintaining a potential level of return or increasing your potential returns while maintaining the current level of risk.

Most investors know that diversification helps to reduce portfolio volatility. However, simply owning numerous stocks or various mutual funds doesn't provide sufficient diversity. A portfolio with many investments may not have properly diversified and weighted asset classes. If your portfolio has a limited number of specific asset classes, then it won't have maximum diversification or reduction of volatility.



This chart illustrates two hypothetical asset classes with negative correlation, fluctuating in opposition. When A is up, B is down, so the investor who owns both evens out volatility. The individual volatility of each asset class offsets the risk of the overall portfolio, allowing for maximum return with the least amount of volatility. In the real world, no asset class completely offsets the risk of another. Fortunately, MPT does not require this to be effective. As long as each individual asset class has some degree of neutral correlation compared to the others, volatility will be dampened and portfolios will have a potential for greater return consistent with their desired level of risk. We tailor each portfolio to the client's preferred risk level, allowing the risk mitigation principles shown here to generate highly efficient risk/reward portfolios.

For a more in-depth explanation of this Nobel Prize-winning investment methodology and how it can benefit you, contact us for a complimentary consultation with one of our wealth advisors.



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