

# Mutual Funds and the Limits of Diversifying

## FUND TRACK

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Diversify! That's always the mantra to deal with stock-market turmoil.

But this week's tragedy-scarred trading demonstrates the power—but also the limitations—of the oft-repeated advice to spread one's mutual-fund dollars among various types of portfolios.

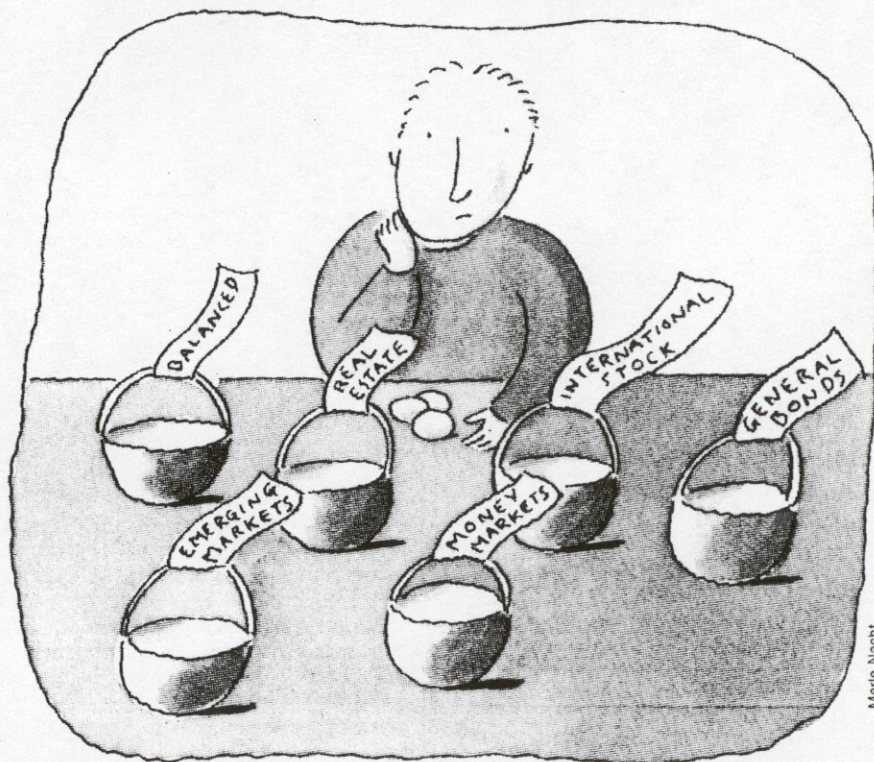
Money-market funds and most types of bond funds have held their value in recent days, cushioning losses for investors who included those holdings along with their stock funds. "Bonds have been a savior for me," says Keith Vanderlinden, a Nebraskan whose half-stock, half-bond portfolio declined by less than 2% on Monday, when the average U.S. stock fund fell 5%. His bond holdings, all in Vanguard Inflation-Protected Securities Fund, rose 0.8% that day.

But in the wake of the horrific attacks of Sept. 11, almost all varieties of diversified stock portfolios—whether invested in the U.S. or overseas, in large companies or in small, in fast-expanding "growth" stocks or seemingly bargain-priced "value" ones—have done poorly. People "weren't making those distinctions" among which types of securities to sell, says William Berg, a financial adviser in Portland, Ore.

That's no surprise, Mr. Berg adds. "Diversification is a great long-term plan," he says, but "diversification gets oversold as a protection against crises." Over longer periods, he says, diversification still increases the odds of earning solid returns and helps people avoid getting caught up in market manias such as the recent Internet-stock bubble.

The average diversified U.S.-stock fund declined 7.9% in the first three days of trading this week after the markets reopened from the tragedy-induced shutdown, according to Lipper Inc. Portfoliowide losses were significantly lower for investors who also own money funds, which aim to maintain a

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## Diversification Helps... but It Has Its Limits

Performance of various mutual-fund categories since last week's disasters and over longer periods. All returns through Wednesday.

Fund type	From Sept.10	Year-to-date	Past 3 years, annualized
Gold-oriented	+3.5%	+16.8%	+1.8%
Intern. U.S.-govt. bond	+0.9	+6.9	+5.6
Money market	+0.03	+2.9	+4.9
Real-estate	-3.8	+1.6	+9.0
Balanced*	-4.2	-11.6	+3.1
International-stock	-5.9	-28.5	-1.1
International small-cap	-7	-28.4	+4.6
Diversified U.S.-stock	-7.9	-23.3	+4.1
Emerging markets	-9.4	-20.2	+3.4
Natural resources	-9.7	-20.1	+8.9

\*Holds a mix of stocks and bonds.

Source: Lipper

# Postattack Volatility Shows Diversification's Limits

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fixed \$1 share price, or who own bond funds, many varieties of which either rose or declined by less than 1% over that period. (One exception is high-yield "junk" bond funds, which slid 3.1%.)

As a result, recent days have underscored the fact that there is more to investing than just the stock market. Anxious investors sometimes forget about the mitigating impact of their nonstock holdings and mistakenly "equate investing with what is happening in the Dow or the S&P," says financial adviser Tom Orecchio of Old Tappan, N.J., referring to the Dow Jones Industrial Average and the Standard & Poor's 500-stock Index.

Investors also saw the power of diversification this week if they had stashed a slice of their portfolios in gold funds, a long-lagging category that gained 3.5% in the three-day period after the market's reopening. The unusual **Oppenheimer Real Asset Fund**, which delivers returns linked to commodities prices, surged 2.8% on Monday but gave back those gains in the next two days.

Among categories of diversified stock funds, though, the performance numbers have been consistently grim and were especially uniform on Monday, the day U.S.

stock trading resumed after a four-day hiatus. The average international-stock fund fell 5.1% on Monday, according to Lipper, just a shade worse than the average 5.0% loss for all U.S.-stock funds.

And among the 12 varieties of diversified U.S. stock funds identified by Lipper—such large-cap growth funds and small-cap value ones—the one-day losses were tightly clustered, ranging between a negative 4.7% and a negative 5.7%.

Adding international-stock funds to portfolios has paid off very well for investors in some past time periods, but not so far this year. Diversified international stock funds have declined an average 28.5% in 2001, exceeding the average 23.3% decline for diversified U.S. stock funds. And while funds investing in small stocks overseas and in the world's developing nations may be most likely to diverge in performance from the U.S., they've tumbled badly this year as well.

While not working this week, using various styles of U.S.-stock funds to spread their portfolio risk has helped investors steer a course between feast and famine over longer periods.

Remember how, two or three years ago, large-cap growth funds were soaring and putting other categories to shame? Those large-cap growth funds have tumbled an average 34.3% in 2001, while small-cap value funds, which had long trailed the pack, had lost only 0.7% this year as of Wednesday.

"Looking back at the year to date, diver-

sification has worked extraordinarily well," says Harold Evensky, a financial adviser in Coral Gables, Fla.

Despite the strong showing recently, a number of financial advisers remain unenthusiastic about gold funds. Investors who fear some sort of global financial collapse may indeed want to own some gold coins that they could use to buy goods, Mr. Evensky says. But if you want that sort of tangible "disaster hedge," he says, gold stocks or gold mutual funds won't work.

As a small position in a diversified portfolio, though, Messrs. Evensky and Orecchio both favor **Oppenheimer Real Asset**, which invests in derivative securities whose returns are linked to the prices of commodities, including oil and natural gas and industrial and precious metals. Commodity prices often move in the opposite direction from stock prices, as was the case Monday.

Among other types of funds investors have sometimes looked to for diversification, natural-resources funds have been weak this year, but strong over the past few years. As of Wednesday, real-estate funds on average still had positive returns year to date. For those looking for diversification through one-stop shopping, balanced funds combine stocks and bonds in a single package, but have been negative performers so far this year.

Investors who strive to diversify their portfolios should periodically rebalance their holdings—putting more money in the asset classes that have done poorly and cutting their percentage exposure to assets that have done best.

On Wednesday, Mr. Orecchio was buying U.S. and international stock funds for clients whose portfolios had grown disproportionately heavy in categories such as bonds. Also on Wednesday, Mr. Vanderlinden, the investor from Nebraska, sold some of his bond fund and put the money into stock funds, including **Vanguard Total Stock Market Index Fund**.

"I decided to do my annual rebalancing now, after the huge hit the market took," the 63-year-old retiree explained. "America and the market will recover."

## Money-Fund Assets Increase \$75.39 Billion

*By a WALL STREET JOURNAL Staff Reporter*

WASHINGTON — Money-market mutual-fund assets rose \$75.39 billion to \$2.210 trillion for the week ended Wednesday, the Investment Company Institute said.

Assets of the 1,035 retail-class shares increased \$8.64 billion to \$1.1 trillion from a revised \$1.09 trillion, the institute said. Among retail-class shares, assets of the 670 taxable shares increased

\$8.47 billion to \$911.88 billion, while assets of the 365 tax-exempt shares increased \$164.2 million to \$187.22 billion.

Assets of the 922 institutional-class shares increased \$66.76 billion to \$1.111 trillion from a revised \$1.044 trillion. Among institutional-class shares, assets of the 725 taxable shares increased \$67.26 billion to \$1.036 trillion, while assets of the 197 tax-exempt shares decreased \$509.2 million to \$75.16 billion.