

At Thun Financial Advisors we like to emphasize that proper diversification is the single most important aspect of successful investing. Nevertheless, it is actually quite rare to find an investor who has a fully diversified investment portfolio. Many investors who believe they are diversified are at best only partially diversified. Frequently, we find investors who are not just under-diversified, but who are thoroughly un-diversified. Under-diversification typically takes the form of too much cash; over concentration in stocks; over-concentration in US stocks; no exposure to commodities, small cap stocks, emerging markets or real estate. In some cases, an investor has all their money invested in just a few stocks and/or bonds, often times in the same country and industry sector.

At best, failure to fully diversify implies that an investor is likely to suffer lower rates of return for the amount of investment risk being assumed than would be the case with greater diversification. At worst, heavy concentration of a portfolio in just a few investments exposes an investor to a catastrophic loss due to the occurrence of a random, unpredictable event such as the bankrupting of Enron or the sudden collapse of a hedge fund, ala Madoff.

Alternatively, by thoroughly diversifying our portfolios across many different asset classes, we can expect to achieve lower risk and lower volatility than would be the case with a heavily concentrated, undiversified portfolio. And we can do so without having to accept lower expected returns. Diversification is not a guarantee against losses, but gains AND losses will tend to be less dramatic while the average gain over the long-term will be higher when we are fully diversified. Furthermore, by investing in each of the different asset classes through index funds, we eliminate the risk that any individual company bankruptcy or investment fund fraud can have a meaningful impact on our portfolio and put our financial well-being at risk. That is why we call diversification the only “free lunch” in investing. It alters the balance between risk and reward in favor of reward.

To demonstrate how Thun Financial employs this powerful tool on behalf of clients, we looked at the performance of three different portfolios over the last 10 years. Each portfolio is invested across a range of investments, and each portfolio is successively more diversified. The third portfolio is the standard Thun Moderate Risk Model Portfolio upon which all Thun client portfolios are based. Returns are calculated based on the actual return of the underlying indices adjusted by the net expense ratio charged currently by index funds that track the indices.¹ Here is what we found:

¹ The Thun Moderate Risk Model Portfolio is comprised of fifteen distinct asset classes represented by different indices. All fifteen indices are currently tracked by index funds that mimic them, but most of the funds have existed for less than 10 years. Therefore, to get an accurate, implied after-fee historical, “investible” performance for the full 10 years, we tracked the historical index adjusted downward by the current net expense ratio of tracking index fund.

Portfolio #1: This portfolio is 100% invested in a US S&P 500 stock index fund.

Portfolio #2: This is a moderate risk portfolio of 40% US stocks, 30% international stocks and 30% high quality bonds.

Portfolio #3: Is the Thun Moderate Risk Model Portfolio. This portfolio is fully diversified across fifteen different asset classes comprised of stock, bonds, real estate and commodities.

Portfolio		1999-2008 average annualized return	standard deviation	biggest annual gain	biggest annual loss	total return over period
Portfolio #1	All US Stock Portfolio	0.56%	20.53%	28.63%	-37.31%	-14.54%
Portfolio #2	Moderate Risk Global Stock/Bond Portfolio	2.93%	15.88%	24.60%	-27.45%	18.97%
Portfolio #3	Thun Moderate Risk Model Portfolio	6.94%	15.64%	28.59%	-27.94%	75.44%
	cash (Imoney MFR Average Money Fund)	2.68%	1.77%	5.42%	0.46%	30.10%

By any measure, the last 10 years have not been good ones for global investors. Developed economy stock markets around the world had their worst decade of returns since the 1930's. Nevertheless, as the table above clearly demonstrates, the highly diversified Portfolio #3, the Thun Moderate Risk Model Portfolio, delivered a respectable 6.94% annualized return, better than either the all stock or the stock/bond portfolios. Just as importantly, it did so with lower risk and lower volatility than either of the other two portfolios. (We measure risk by looking at standard deviation, a measure of volatility. The higher the standard deviation, the higher the volatility and hence the higher the risk.) Furthermore, the Thun Portfolio's biggest gain year essentially matched the best upside of all three funds even though its biggest loss year did no worse than the least bad performance of the three.

Part of the reason the Thun Moderate Risk Portfolio did well is because of its exposure to commodities, which generated better returns than either stocks or bonds over the 10 years being considered. This underscores the important role played by commodities in achieving the full benefit of diversification. Commodities prices have low correlation to stock prices, even though they generate relatively high, stock-like long-term returns. In fact, looking at data back to 1970, commodities actually have had negative correlation with US stocks. That is to say, when stocks go up, commodities have tended to go down and visa versa. The result is that by diversifying across stocks and commodities, the volatility of the overall portfolio is reduced, even though returns are not. (Adding in real estate and bond investments also augments diversification and further reduces portfolio volatility.) Going forward, commodities may or may not continue to outperform other asset classes. However, they are likely to retain their low correlation to stocks, and hence act to reduce overall portfolio volatility and risk. The example of commodities underscores a key principle of sound portfolio construction: to combine different kinds of investments that have relatively high potential return but which are as weakly correlated to one another as possible. Employing this principle, and hence fully reaping the benefits of diversification, requires investing across the full range of global assets, including stocks, bonds, real estate commodities and their various sub-classes.

Portfolio #1: All US Large Cap Portfolio

weight	asset class	Index Benchmark	Average annual return 1999-2008	current ETF/Fund expense ratio	expense adjusted weighted return
100.00%	Stocks				
100.00%	US Large Cap	S&P 500 index	0.61%	0.09%	0.52%
100.00%	weighted totals	-	0.61%	0.09%	0.52%

Portfolio #2: Moderate Risk Global Stock and Bond Portfolio

weight	asset class	Index Benchmark	Average annual return 1999-2008	current ETF/Fund expense ratio	expense adjusted weighted return
70.00%	Stocks				
40.00%	US Large Cap	S&P 500 index	0.61%	0.09%	0.21%
10.00%	Developed Asia	MSCI Pacific Index	6.13%	0.18%	0.60%
20.00%	Developed Europe	MSCI Europe	4.35%	0.18%	0.83%
30.00%	Bonds				0.00%
15.00%	Short-Term High Grade	Barclay's 1-5yr Govt/Credit Index	4.84%	0.82%	0.60%
15.00%	Investment Grade Munis	Barclay's 7 Year Municipal bond Index	4.84%	0.20%	0.70%
100.00%	weighted totals	-	3.18%	0.24%	2.94%

Portfolio #3: Thun Moderate Risk Model Investment Portfolio

weight	asset class	Index Benchmark	Average annual return 1999-2008	current ETF/Fund expense ratio	expense adjusted weighted return
50.00%	Stocks				
10.00%	US Large Cap	S&P 500 index	0.61%	0.09%	0.05%
5.00%	US Mid Cap	MSCI US Mid-Cap Index	6.36%	0.13%	0.31%
5.00%	US Small Cap	MSCI US Small-Cap Index	5.40%	0.10%	0.27%
5.00%	Developed Asia	MSCI Pacific Index	6.13%	0.18%	0.30%
10.00%	Developed Europe	MSCI Europe	4.35%	0.18%	0.42%
5.00%	Global Developed Small Cap	S&P ex-US Developed World Small Cap *	7.52%	0.56%	0.35%
10.00%	Emerging Markets	MSCI Emerging Markets Index	16.34%	0.27%	1.61%
30.00%	Bonds				
10.00%	Short-Term High Grade	Barclay's 1-5yr Govt/Credit Index	4.84%	0.82%	0.40%
5.00%	US Treasuries	Ishares 3-7 year US Treasury Index	5.08%	0.15%	0.25%
5.00%	TIPs (Trsy Infl Protected)	Ishares US Trsry Inflation Protected index **	6.24%	0.20%	0.30%
10.00%	Investment Grade Munis	Barclay's 7 Year Municipal bond Index	4.84%	0.20%	0.46%
10.00%	Real Estate				
5.00%	REITS	MSCI US REIT Index	9.86%	0.10%	0.49%
5.00%	GLOBAL REITS	SPDR DJ Wilshire Int Real Estate Index ***	11.92%	0.60%	0.57%
10.00%	Commodities				
5.00%	Diversified Commodities	Goldman Sachs S&P Commodities Index	12.54%	0.75%	0.59%
5.00%	Precious Metals	Gold Price Index	12.38%	0.40%	0.60%
100.00%	weighted totals	-	7.27%	0.31%	6.96%

* S&P ex-US Small Index data available from 2001 only; MSCI EAFE index used as proxy for 1999-2000

** US TIP index data available from 2001 only; US Treasury Index used as proxy for 1999-2000

** Global REIT index available from 2002 only; US REIT index used as proxy for 1999-2001

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