

Market Analysis, Research & Education

A unit of Fidelity Management & Research Co.



Is Diversification Dead?

Summary

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Key Takeaways:

- Never in modern history have so many asset classes declined together and with such magnitude as they have during the past few months.
- With only cash and ultra-safe Treasury bonds spared, the widespread carnage in the securities markets has prompted some investors to question the strategy of portfolio diversification.
- The alternative to diversification—particularly investing in one safe asset class, such as cash—generally has been a significantly less successful strategy over longer time horizons.
- Investors should be careful not to expect that a highly atypical three-month period will be the norm going forward, particularly when the history of the markets suggests otherwise.

Portfolio Construction: Is Diversification Dead?

Asset Class Total Returns (through Nov 2008)

| Asset Class | Past 3 Months | YTD 2008 | Past 20 Years* |
|----------------------------------|---------------|----------|----------------|
| U.S. Treasury Bonds | 5.8 | 10.0 | 7.6 |
| Cash | 0.3 | 1.6 | 4.3 |
| Inflation | -1.7 | 2.5 | 3.0 |
| Municipal Bonds | -5.4 | -3.9 | 6.2 |
| Investment-Grade Corporate Bonds | -8.5 | -8.8 | 7.0 |
| U.S. Stocks | -29.6 | -37.7 | 8.5 |
| High Yield Bonds | -29.7 | -31.5 | 6.2 |
| Foreign Developed-Country Stocks | -35.4 | -46.3 | 3.2 |
| Emerging-Market Stocks | -44.6 | -56.6 | 9.9 |
| Real Estate Stocks | -47.5 | -46.5 | 8.3 |

* Past 20-year performance reflects average annual returns.

Source: Ibbotson, FMRCo (MARE) as of 11/30/2008. Past performance is no guarantee of future results. You cannot invest directly in an index. See footnotes for important index definitions. Asset class performance represented by the following indices: U.S. Treasury Bonds – Barclays Capital (BarCap) U.S. Treasury Index; Cash – Ibbotson Associates SBBI 30 Day TBill Total Return Index; Inflation – Ibbotson Associates SBBI U.S. Inflation; Municipal Bonds – BarCap Municipal Index; Investment-Grade Corporate Bonds – BarCap Credit Index; U.S. Stocks – S&P 500 Index; High Yield Bonds – Merrill Lynch High Yield Master II Index; Foreign Developed-Country Stocks – MSCI EAFE Index; Emerging-Market Stocks – MSCI Emerging Markets Index; Real Estate Stocks – FTSE NAREIT Equity-Only Index.

Perfect Storm: Almost No Place to Hide

- ▶ The scope of the sell-off in multiple asset classes during the past three months and on a year-to-date (YTD) basis is unprecedented in modern times (see table, left).
- ▶ The broad-based three-month decline is highly unusual because it ensnared many fixed-income assets that had been considered relatively safe and had demonstrated the ability to hold up well during previous bear markets in stocks. More specifically:
 - High-quality corporate bonds tumbled 8.5%.
 - Municipal bonds, which are highly-rated credits and have a very low historical rate of default, fell 5.4%.
- ▶ Only ultra-safe cash and Treasury bonds fared well and provided some portfolio stability for investors.
- ▶ This perfect storm was driven by the worst credit market crisis and biggest threat to the U.S. financial system since the 1930s.
- ▶ Coupled with the steep global economic downturn it precipitated, these developments led to a crisis of confidence that provoked many investors to flee to safety (cash/Treasuries) and provoked many financial entities to sell all other assets to de-leverage their balance sheets.

Long-Term Case For Diversification Still Compelling

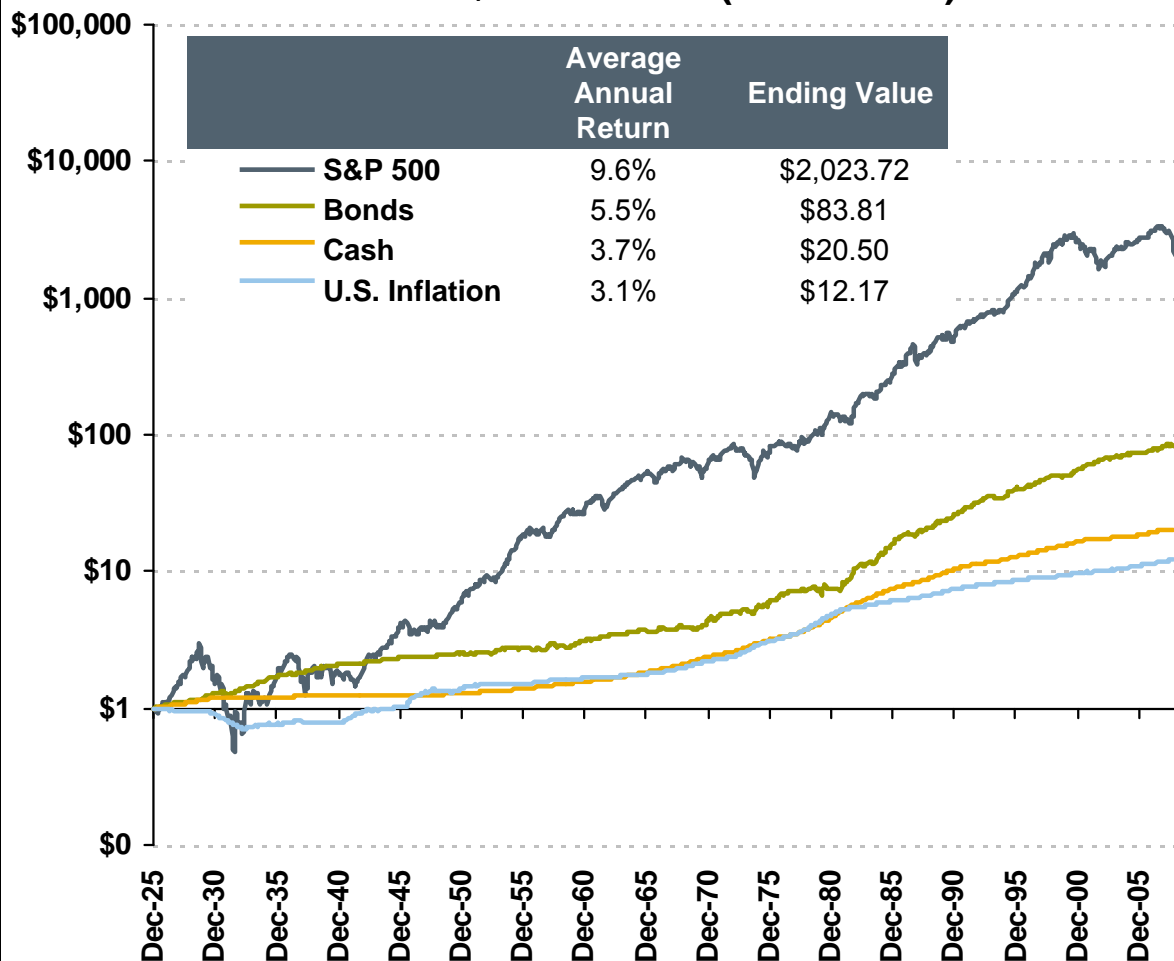
- ▶ It's important to keep in mind that over some short-term periods, diversification at times may look ineffective, but over longer time frames, it has been valuable.
- ▶ For example, during the past 20 years, most stock categories provided higher returns than bonds and cash. U.S. stocks averaged a solid 8.5% annual return during the past 20 years, despite the current decade being one of the worst ever (see table, left).
- ▶ All bond categories outperformed cash over the past 20 years, despite recent turmoil.
- ▶ While recent losses may be even more difficult to endure than in the past given the scope and magnitude of the widespread decline, investors should be careful not to expect these short-term results to last forever.

Diversification does not ensure a profit or guarantee against loss.



Alternative (Concentration in Cash) Not a Compelling Long-Term Strategy

Value of \$1 Invested (1925-2008)



Source: Ibbotson, FMRCo (MARE) as of 11/30/2008. Figures assume reinvestment of capital gains and dividends, but does not reflect sales charges or taxes, which would lower these figures. Past performance is no guarantee of future results. You cannot invest directly in an index. See footnotes for important index definitions. **Cash** – Ibbotson Associates SBBI 30 Day TBill Total Return Index; **Inflation** – Ibbotson Associates SBBI U.S. Inflation; **Bonds** – MARE Custom Bond Index (see footnotes page for details.)

Investing in Cash Has Been Safe But Less Rewarding

- ▶ What's the alternative to maintaining a diversified portfolio in today's markets? Staying invested in cash or Treasury bonds?
- ▶ While cash-like investments or Treasury bonds have been the only place to find shelter from the recent storm, concentrating portfolios in these risk-free categories is commonly a far less successful strategy than being diversified in multiple asset classes over the long term.
- ▶ During the past 80 years, returns to cash significantly lagged investment-grade bonds and large-cap U.S. stocks (see chart).
 - Further, cash has barely outpaced the rate of inflation over the long-term, and provided even less after taxes.
- ▶ In addition, due to the unusually high returns on U.S. Treasury bonds during the past few months, investors should beware that these bonds are currently offering extremely low yields, making the prospects for a repeat performance extremely challenging.
- ▶ Over long-term time horizons, investors who've been willing to diversify into stocks, bonds and other asset classes typically have experienced higher returns.

Investment Implications

- ▶ After a very challenging 2008, it's important to recall that one of the basic principles of investing is that there is a trade-off between risk and return that has been true over time—more risk generally means more return, and vice versa.
- ▶ Long-term investors should be careful not to expect the highly correlated declines of multiple assets classes during the past three months to be the norm going forward, particularly when the history of the markets suggests otherwise.
- ▶ Although the recent meltdown in various asset classes was painful for most investors, it's worth taking into consideration that the alternatives to diversification have generally not fared well over longer time horizons.

Investment decisions should be based on an individual's own goals, time horizon and risk tolerance.

Footnotes

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made in any index.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

The municipal market is volatile and can be significantly affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a debt security to decrease.

The S&P 500[®], a market capitalization-weighted index of common stocks, is a registered service mark of the McGraw-Hill Companies, Inc. and has been licensed for use by Fidelity Distributors Corporation.

Barclays Capital[®] (BarCap) U.S. Treasury Index- an index which covers public obligations of the U.S. Treasury with a remaining maturity of one year or more. The BarCap Aggregate Bond Index is an unmanaged market value weighted performance benchmark for investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year. BarCap U.S. Credit Index—Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The BarCap U.S. Municipal Bond Index covers the USD-denominated long term tax exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Ibbotson Associates SBBI U.S. Inflation – An inflationary indicator based on the Consumer Price Index (CPI) that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. CPI values reflect mid-month price levels, thus Ibbotson Associates estimates the most current month by taking the average rate of the previous two months to match month-end asset class returns.

Changes in real estate values or economic conditions can have a positive or negative effect on issuers in the real estate industry, which may affect your investment.

NAREIT Equity-Only Index. The unmanaged National Association of Real Estate Investment Trusts (NAREIT) Equity Index is a market-value weighted index based upon the last closing price of the month for tax-qualified REITs listed on the NYSE.

MARE Custom Bond Index – Prior to 1976, 34% of the custom index is composed of the Ibbotson U.S. Long-Term Corporate Bond Index and 66% is composed of the Ibbotson U.S. Intermediate-Term Government Bond Index. From 1976 on, the index returns are composed of the BarCap Aggregate Bond Index. The Ibbotson US Intermediate Government Bond Index is a custom index designed to measure the performance of US Government Bonds. The Ibbotson US Long-Term Corporate Bond Index is a custom index designed to measure the performance of US Corporate Bonds.

Ibbotson Associates SBBI 30 Day TBill Total Return Index – An index which reflects U.S. Treasury Bill returns. Data from The Wall Street Journal are used for 1977-Present; the CRSP U.S. Government Bond File is the source from 1926 to 1976. Each month a one-bill portfolio containing the shortest-term bill having not less than one month to maturity is constructed.

The Morgan Stanley Capital InternationalSM (MSCI[®]) Europe, Australasia, Far East Index (EAFE), an unmanaged market capitalization-weighted index, is designed to represent the performance of developed stock markets outside the United States and Canada. MSCI Europe Index is a market capitalization weighted index of over 550 stocks traded in 14 European markets. The MSCI[®] Emerging Markets (EM) Free Index is a market capitalization weighted index of over 850 stocks traded in 22 world markets.

Fidelity Investments Institutional Services Company, Inc., 82 Devonshire Street, Boston, MA 02109

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