

# Pie vs. Pyramid

## The Battle of Risk and Reward in Your Portfolio

**S**tatistics often have the effect of dulling our sense of reality. When government and businesses toss out percentages and lump us into pre-determined demographic groups, it's hard to internalize whatever message they're trying to convey. We get lost in the coldness of the data--the impersonal nature of raw numbers. Unless, of course, the statistic is so startling, so verifiable, it makes you stop dead in your tracks and nod in bewildering agreement.

Case in point: Tens of millions of American households lost a substantial portion of their portfolio after the market crash in

2008. But even in the year before the market plummeted, Americans had lost 20%

of their retirement savings. From

September 2007 to December

2008 the stock market lost \$11 trillion in value

– a 47% drop! This alarming figure has been overshadowed by the even more incredible

fact that the

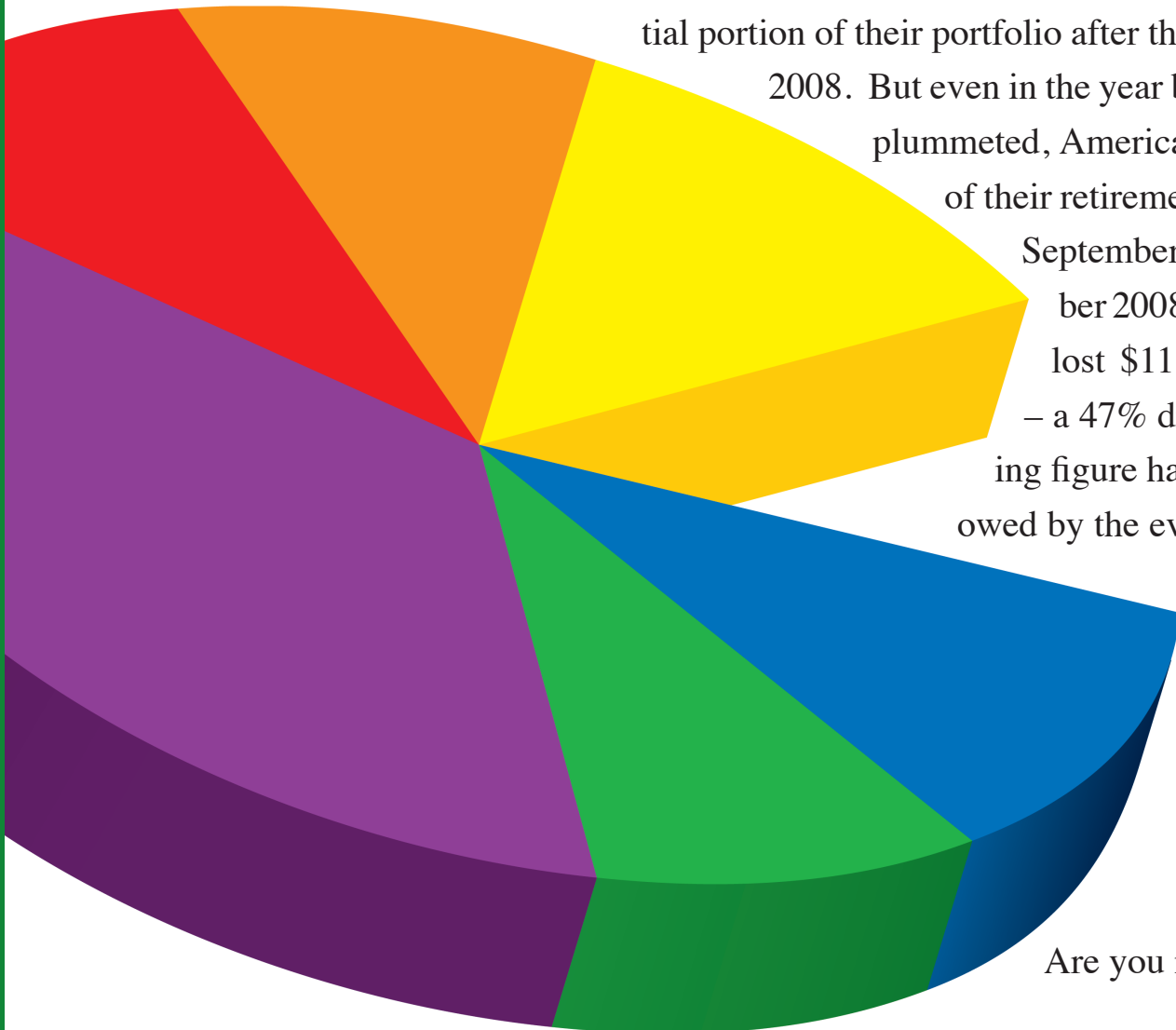
most recent

market meltdown has cost

Americans

10.2 trillion dollars in losses.

Are you nodding?



## Pie vs. Pyramid

If you're among those whose portfolios declined as a result of the crash, no doubt the reporting of these statistics is a painful reminder of your losses. While we're often taught to learn from our mistakes, in the case of investing it's difficult to know both where we went wrong and how to prevent it from ever happening again; after all, we're not experts... and we're not expected to be. So to find out the answers we likely turn to the people who are--namely, the money managers and stockbrokers who recommended these failed investment strategies. Of course, talking to the experts will likely yield several different reasons for a plummeting portfolio. From war to corporate and mutual fund scandals and, most recently, the collapse of the real estate and mortgage market and major financial institutions, you'll likely see fingers pointed in every possible direction. Yet, a closer look reveals these events might not have contributed as much to these losses as initially thought. In fact, this phenomenon may actually be the result of something much more insidious and less obvious. But to get there, we first have to examine why those otherwise accepted scapegoats are merely excuses which hold little or no veracity.

Did the bursting real estate bubble and the collapse of the financial industry with the subsequent market downturn really cause the loss in our portfolios as many of the pundits insist? While this catastrophic event may have contributed to some of the losses experienced within the

last three years, it certainly doesn't account for all. The fact is that the economy was already experiencing a recession when the bubble burst. But maybe the most compelling evidence comes when you look at the numbers.

In the early 2000s, market experts were blaming the huge losses in investor portfolios on the 9/11 terrorist attacks. But the fact of the matter is that by October 16th, a little over a month after the attack on the Twin Towers, the S&P 500 had already reached its September 10th level. Two years later, by September, 2003, the Nasdaq was up 10 percent from pre 9/11 totals. In addition, the Dow Jones closed at approximately 9,600 on September 10, 2001. Although we can all acknowledge 9/11 had some affect on investment losses, we can also agree that it wasn't the beginning of the end that led to 80% losing half or more of their portfolio. Similarly, in today's market crisis, those same experts are quick to chalk the entire downturn up to the real estate and mortgage market collapse. Is this actually the case? Looking at the facts of the matter, it is easy to see that the real estate and mortgage meltdowns are scapegoats for a much simpler explanation. In fact, the Dow Jones Industrial Average over the 10 year period ending December 31, 2008 only realized gains of 1.66%.

Further, in the past 5 years is down 1.12% overall. This during a period of record gains in real estate values in the United States.

The next excuse represents the other big newsmaker and political talking point during the past few years: over-leveraging of financial institutions. But unless you were heavily invested in the finance companies involved

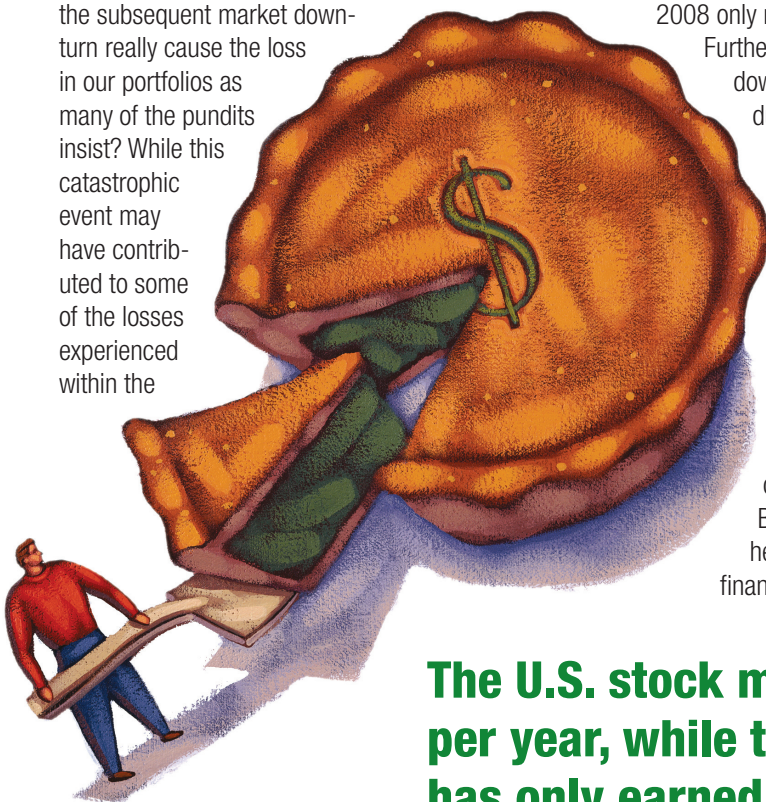
in this debacle, your portfolio would not have been heavily affected. And that brings us to the final nail in the coffin for the financial markets -- the multitude of Ponzi schemes and outright frauds exposed when the "tide went out" (as Warren Buffet is famous for saying). Specifically, the Madoff Ponzi scheme, which was exposed in late 2008. It is alleged that Madoff capitalized on his reputation as a man in the know to bilk his investors, including charitable organizations, out of a purported \$65 billion dollars. Soon to follow was the Stanford off-shore bank scandal and many others. It should be noted that these scandals were revealed after the market meltdown, and in fact, may not have surfaced if not for the market collapse.

With more than 95 million Americans invested in mutual funds and a combined \$7 trillion in assets, these products were once the darlings of the modern investor... But now? "The mutual fund industry is the world's largest skimming operation -- a \$7 trillion trough from which fund managers, brokers, and other insiders are steadily siphoning off an excessive slice of the nation's household, college, and retirement savings," explains Senator Peter Fitzgerald, chairman of the Senate Subcommittee on Financial Management. The "beat up on mutual funds" bandwagon is in full swing... Even those professionals and popular investing websites who convinced you to invest in mutual funds are suddenly crying foul.

### An Investment Gut Check

It's no surprise that many Americans with retirement portfolios languishing at levels from a decade ago are wondering how they could have lost so much, so quickly. Incidentally, 77% of the accumulated wealth in this country is held by people over age 55, so it's no secret what group was left most devastated by the losses. They were all likely scratching their heads in disbelief at this sudden and significant drop off; after all, these investors had been assured by their brokers and planners that they were properly "diversified."

**The U.S. stock market has earned a return of 13% per year, while the average mutual fund investor has only earned a return of approximately 2%!**



Diversification teaches investors to avoid putting all of their eggs in one basket, and it's intended to help protect investors from market fluctuations. But if investors were truly diversified, why did 80% lose at least half or more of their entire portfolio?

We've already established it wasn't solely caused by the bursting of the real estate market bubble, sub-prime mortgages, the now-infamous Credit Default Swaps that brought down some venerable Wall Street names, nor by the ever multiplying Ponzi schemes and financial frauds... So, what did happen? Risky and often irresponsible investments, that's what. John Bogle, the founder of Vanguard Funds, one of the most prominent mutual fund companies in the world, focuses in on the mutual fund managers who should have seen the train wreck coming but missed it altogether, "Where the hell were the funds' security analysts? They said they couldn't understand the balance sheet. Then why did they buy the stock?"

But if these investments were as precarious as Mr. Bogle notes, how could investors have been convinced they were properly diversified? The proof may be in the pudding... Or rather the pie.

When purchasing stocks or mutual funds, many investors are shown an asset allocation model in the form of a pie chart. Asset allocation is the process of dividing a portfolio among major asset categories, like bonds, stocks, or cash. While the fundamental purpose of the model is to reduce risk by diversifying the portfolio, it is mostly used to illustrate a person's allocation in regard to mutual funds, only--funds that are comprised of non-guaranteed investments. If you own mutual funds, you'll likely find a pie chart right on your brokerage statement. The pie chart advises investors to spread their assets throughout the slices of the pie to diversify a portfolio and shield against substantial losses (Figure 1 illustrates a typical Wall Street asset allocation model). It is, in effect, designed to sell mutual funds. Whether you agree with the strategy or not, it seems to have worked quite well. The Securities Industry Association reports that 75% of U.S. financial assets are invested in securities-related products (stocks, mutual funds, bonds, etc.) and 49.5% of U.S.

households are invested in either individual stocks or stock mutual funds.

The gung-ho attitude that led to increased investment in riskier vehicles was based on three fundamental principles: returns, returns, returns. The prospect of higher returns was the fuel that drove us to risk larger percentages of our portfolios, especially with the knowledge that the pie chart would protect us. But was it worth it? During the past 20 years, the U.S. stock market has earned a return of 13% per year, while the average "pie chart" mutual fund investor has only earned a return of approximately 2% per year! Money Magazine columnist, Pat Reginier, put it well in May 2009, "...this crash reminds me that investing in stocks involves two sets of decisions: what to buy and how much... The what isn't so hard. The how much is where you can truly hurt yourself... We ought to have been saying much more often that while stocks may be a good investment, they'll always be risky. Really risky."

### Risk and Reality

Regardless of the actual returns earned, if any of the investors who were flirting with high-risk investments had stopped to take a look at their true risk diversification they might have recognized the potential danger lurking behind their pie chart. Keep in mind, from a strict school of investing, the pie chart found on a brokerage statement is intended for asset allocation, only, and is rarely used to represent the risk diversification within your entire portfolio. Risk diversification is an overall investment strategy that mixes a wide variety of investments in your financial plan to minimize the impact of any one investment on overall portfolio performance.

This is an important point, since many investors tend to believe they are properly diversified merely because they are invested in various types of mutual funds, but this couldn't be farther from the truth. Sure you can be diversified within mutual funds, but that alone does not represent true risk diversification. It would be like having a barrel of oranges and claiming you have a lot of fruit. Sure you have

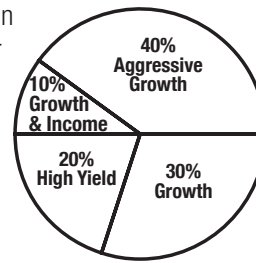


Fig. 1

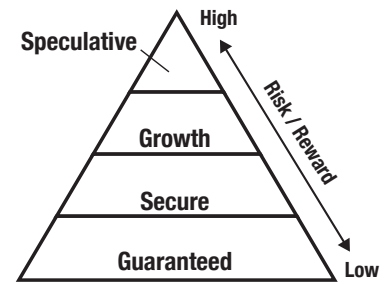


Fig. 2

lots of fruit, but only one type. What about produce of the non-citrus variety?

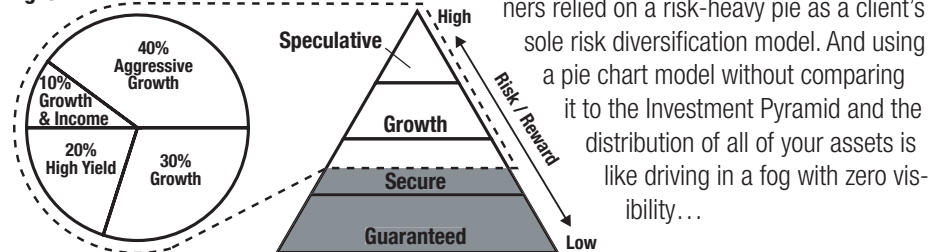
If you're wondering if there's any model that can help you determine your true risk diversification, the good news is there is... the oldest, most widely-accepted risk diversification model: the Investment Pyramid. Unfortunately, too many investors have never been introduced to this fundamental concept. Figure 2 illustrates the Investment Pyramid, a pyramid that is built according to the level of risk. Safe, or guaranteed, investments comprise the foundation and as you move up the Pyramid the riskier the investments become—moving from guaranteed to secure to growth, all the way to speculative at the very top. Each investment type is categorized in the pyramid according to its level of risk. For example, a checking account would be found in the foundation, while arts and collectibles are located in the Pyramid's tip. This model is one of the first concepts taught to aspiring financial planners and brokers. It is, after all, based on the most stable geometric structure—think about the pyramids of Egypt. But why is it so important to investing?

Examine the Pyramid, closely, and you'll notice there is a ratio between the area allocated for guaranteed investments to the area reserved for secure, growth, and speculative investments. This relates to the percentage of a portfolio that an investor would earmark for certain types of investments. In other words, you wouldn't want your portfolio to have a higher percentage of speculative investments than guaranteed investments, right? Doing that would skew the Pyramid by enlarging the top and minimizing the bottom until the structure becomes dangerously unstable.

### Pie vs. Pyramid

So if the Investment Pyramid represents true risk diversification, what does the pie chart

Fig. 3



diversify? Plot a mutual fund pie chart out on an Investment Pyramid and you'll find it doesn't represent the entire Pyramid, but rather just a small portion of risky investments (see Figure 3). It focuses on the secure and growth sections of the Pyramid, without taking into consideration a solid foundation. That being said, it should come as no surprise that at its market peak, the mutual fund industry took in \$555 billion in new money invested in speculative, high-performance funds. As Bogle reveals, "during the great bull market, mutual fund firms have prospered in an era of salesmanship, organizing, offering, and promoting risky funds at the best time for distributors to sell them and the worst time for investors to buy them." And the pie chart was their key selling tool.

If the investors who relied solely on a mutual fund pie chart to diversify had plotted their assets within the Investment Pyramid they would have found something that resembles Figure 4. Not exactly the very definition of stability. This method of investing actually negates all of the structural properties that make pyramids a good basis for a risk diversification model. In reality, the pie chart is more akin to profit diversification, since it diversifies the potential return, not the actual risk.

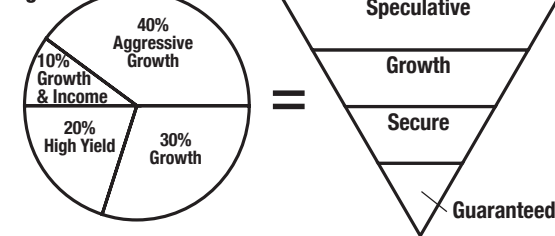
It should also be noted that brokerage firms offer numerous types of pie charts, but determining which one is right for you is not an easy task (keep in mind, there's only one Investment Pyramid). Unless you've plotted your assets out on the Investment Pyramid you can never be sure that the pie chart you're using is properly diversifying you in relation to your age and investment goals. Sadly, the statistics suggest that many brokers and financial plan-

ners relied on a risk-heavy pie as a client's sole risk diversification model. And using a pie chart model without comparing it to the Investment Pyramid and the distribution of all of your assets is like driving in a fog with zero visibility...

## Financial Future Shock

In all fairness, it's not a question of whether or not you should invest in mutual funds, equities, and securities... It's a question of quantity. How much of your portfolio should you put at risk? If 80% of Americans lost half or more of their entire portfolio, it would seem clear that too many of us risked too much. Of course, we thought we were diversified. And diversification was supposed to protect us. But that's all just spilt milk now. The true test will come in the actions we take in the future. As we move ahead, we'll likely be more sensitive to the level of risk in our portfolios and we may even want to consider some of those cold statistics. This isn't meant to disparage the pie chart, when used in relation to solid

Fig. 4



financial planning it could be helpful, but it should always be compared to an Investment Pyramid to ensure it reflects your particular needs.

The Financial Health Research Institute has created a revolutionary tool to help you determine the level of risk in your portfolio using the Investment Pyramid (Check out "Diversifying with the Investment Pyramid: FHRI's Foolproof Way to Understand Risk"). Regardless of your investment strategy, educating yourself about financial planning advice is a safe bet no matter what the investment's risk. And now that you're armed with the Investment Pyramid, you'll know whether that pie you're presented with is in fact just half-baked. ▲

## Investing with History



Throughout our history pyramids have come to represent stable, timeless structures. While many cultures have created pyramid-like monuments, the only true pyramids exist in Egypt. Egyptian pyramids are square in base and have triangular sides, which directly face the points of the compass, slope upwards at approximately a 50° angle from the ground, and meet at an apex. The pyramids of ancient Egypt date back to around 2500 B.C. and were built by monarchs so their mummified bodies would be preserved for eternity. Without modern machinery, one can only imagine just how long construction of these structures took... with each likely requiring thousands of workers and copious amounts of materials. Though Egyptian pyramids were often built of stone blocks laid up in horizontal lines, some were built with mud bricks with stone casings. The largest and finest of all the pyramids in Egypt is the Great Pyramid of Khufu or Cheops (circa 2700 BC). This massive structure is the largest pyramid ever built and one of the seven wonders of the world. It is constructed of a solid mass of limestone blocks which cover 13 acres and towers up to 482 feet!

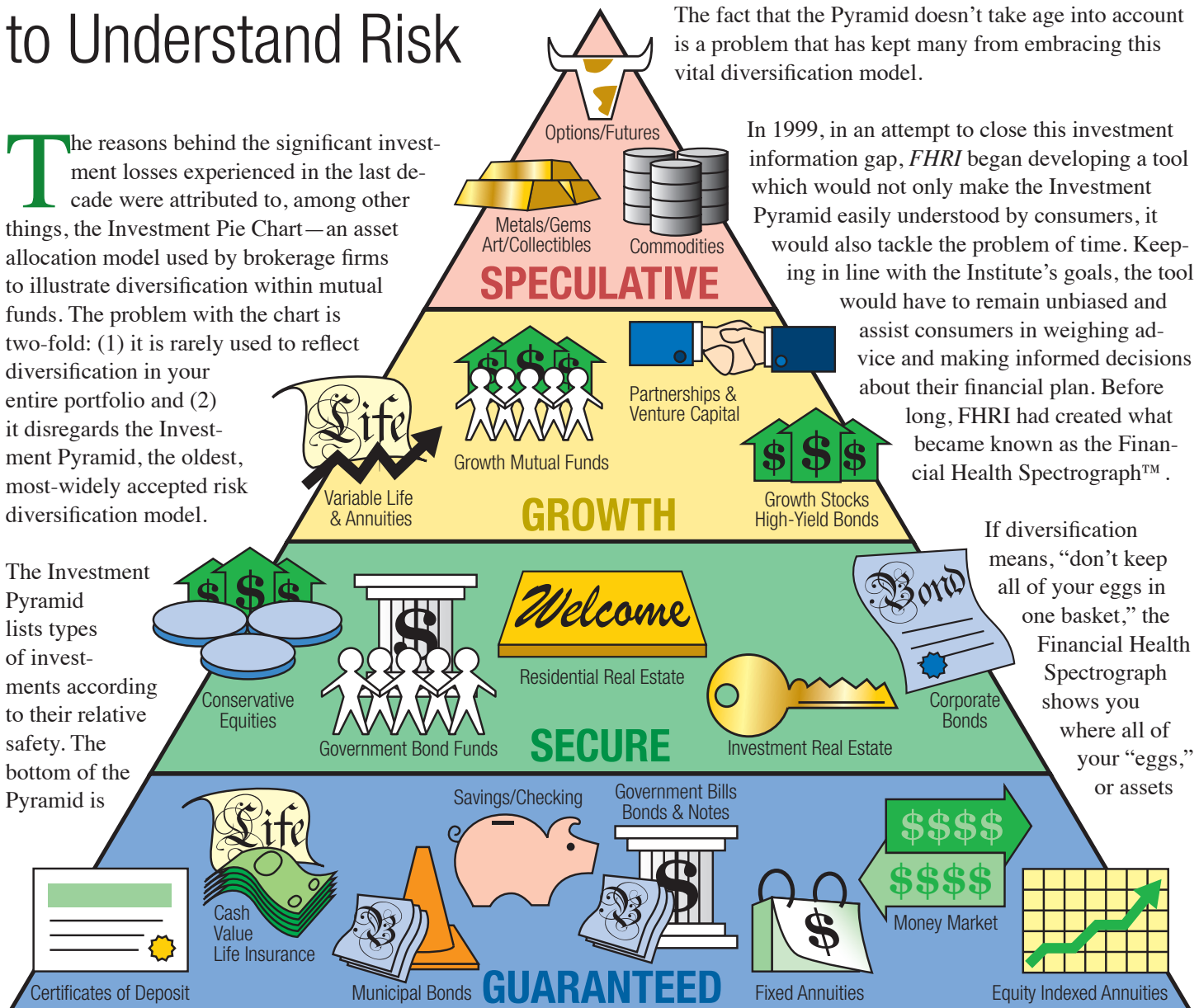
Other pyramid-like structures found around the world include the temples of Mesopotamia, the Mayan pyramids, the Pyramid of Cestius in Rome, and the more modern Transamerica Building found in San Francisco, California.

# Diversifying with the Investment Pyramid

## FHRI'S Foolproof Way to Understand Risk

The reasons behind the significant investment losses experienced in the last decade were attributed to, among other things, the Investment Pie Chart—an asset allocation model used by brokerage firms to illustrate diversification within mutual funds. The problem with the chart is two-fold: (1) it is rarely used to reflect diversification in your entire portfolio and (2) it disregards the Investment Pyramid, the oldest, most-widely accepted risk diversification model.

The Investment Pyramid lists types of investments according to their relative safety. The bottom of the Pyramid is



comprised of lower-risk, including guaranteed investments; the middle is composed of secure and growth investments; and the tip of the Pyramid is devoted to speculative investments. Within the Pyramid, there is a ratio between the area allocated for guaranteed investments to the area reserved for secure, growth, and speculative investments. This relates to the percentage of a portfolio that an investor may want to apportion for certain investments.

Unfortunately, as important as the Investment Pyramid is to balancing your portfolio's risk, it is still lacking in one critical area: Time. Where should you be on the Pyramid and when? Is the Pyramid the same for a thirty-year-old investor, as it is for a seventy-year-old investor? Common sense would dictate that these individuals would not share the same investment strategies; after all, a thirty-year old has plenty of earning years ahead, while a seventy year-old is likely already retired.

The fact that the Pyramid doesn't take age into account is a problem that has kept many from embracing this vital diversification model.

In 1999, in an attempt to close this investment information gap, FHRI began developing a tool which would not only make the Investment Pyramid easily understood by consumers, it would also tackle the problem of time. Keeping in line with the Institute's goals, the tool would have to remain unbiased and assist consumers in weighing advice and making informed decisions about their financial plan. Before long, FHRI had created what became known as the Financial Health Spectrograph™.

If diversification means, "don't keep all of your eggs in one basket," the Financial Health Spectrograph shows you where all of your "eggs," or assets

# Diversifying with the Investment Pyramid

are currently positioned. In other words, it plots your assets across a spectrum of risk, according to your age. Through the use of bell curves, the Financial Health Spectrograph can communicate the “optimal” investment areas for a particular age group. There are two bell curves an investor can choose from, one that represents early years, or pre-retirement, and another that represents later years, or post-retirement.

The pre-retirement bell curve is positioned to the left of the spectrum, and allows for higher relative risk in your portfolio. When you are younger, you have more earning years ahead of you and can afford to allocate a larger percentage of your portfolio to investments that offer a higher potential rate of return, but also have a higher level of risk. If you do lose a portion of your principal investment, you still have time to earn it back. The post-retirement bell curve is positioned to the right of the spectrum, and allows

## If diversification means “don’t keep all of your eggs in one basket,” the Spectrograph shows you where all of your “eggs” are.

for less relative risk in your portfolio. As you get older, and you have fewer earning years relative to the number of retirement years ahead, minimizing risk becomes more important. The less earning years you have remaining the more attention you should focus on conserving your assets.

Incidentally, your highest value asset represents the height of the Spectrograph and everything else is scaled in relation to the value of that asset (For example, if your home was the highest valued asset at \$200,000, the Spectrograph would be scaled to \$200,000).

Also, each color used in the Financial Health Spectrograph corresponds with those utilized in the Investment Pyramid.

### Here are the four types you need to know:

1. Blue represents safe or “Guaranteed” investments. These types lie at the foundation of the Pyramid and on the right side of the Spectrograph.
2. Green represents “Secure” investments that are conservative, but not guaranteed. These are located above the foundation in the Investment Pyramid

## The Evolution of Smarter Investing

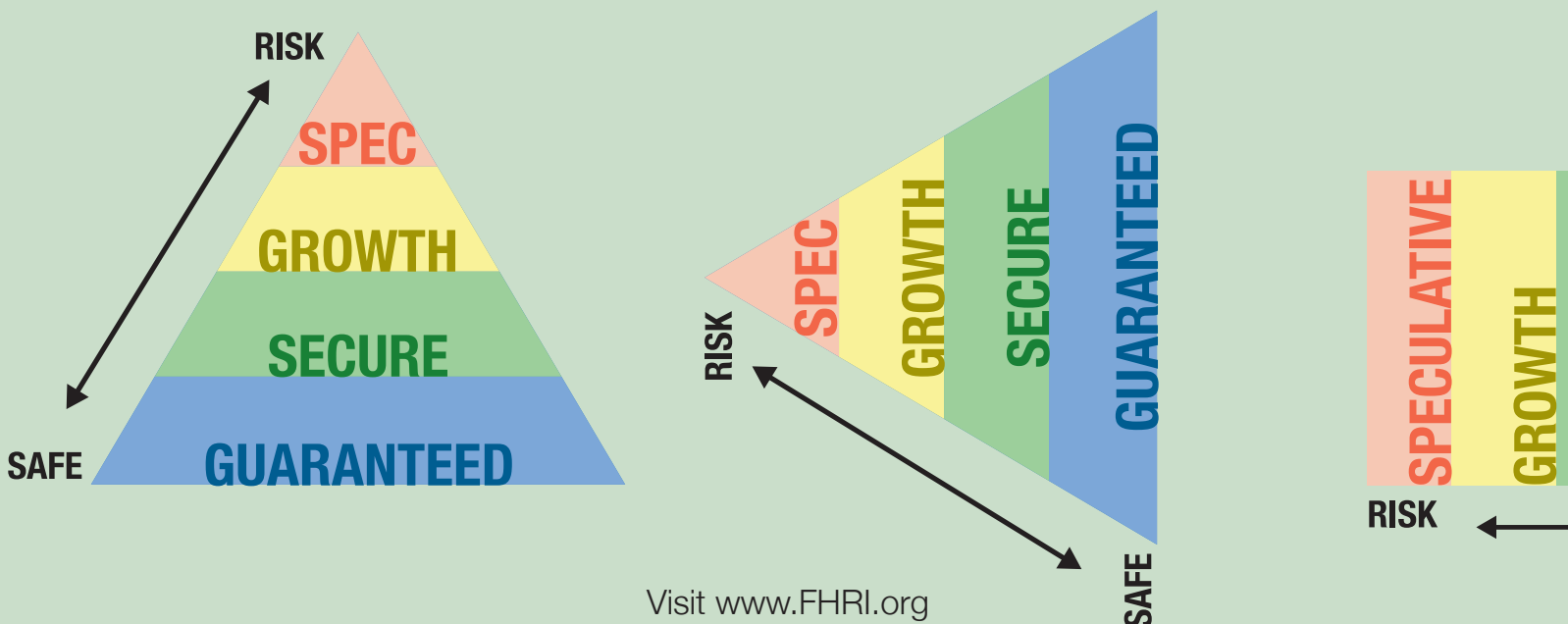
**There’s no doubt that the Investment Pyramid is the oldest and most widely accepted risk diversification model... But how can you put it to good use? In 1999, FHRI took up this challenge and embarked on the following step-by-step process (don’t forget to check out the conclusion on page 4!):**

### Step #1:

FHRI started with the Investment Pyramid. The Pyramid categorized assets in relation to their level of risk, with the safer investments found in the foundation or the guaranteed section and riskier investments found towards the top.

### Step #2:

FHRI recognized that the Investment Pyramid lacked one crucial element: time. How would investors know where they should be on the Pyramid and when? In order to tackle the problem of time, FHRI decided to turn the Investment Pyramid on its side, both figuratively and literally.



and to the left of the blue area on the Spectrograph.

3. Yellow, a cautionary color, represents the “Growth” section of variable, non-guaranteed investments. These investments are located below Speculative and above Secure on the Investment Pyramid and to the left of the green area on the Spectrograph.

4. Red, the danger color, represents “Speculative” investments, which are considered risky. This area lies at the tip of the Investment Pyramid and on the extreme left end of the Spectrograph.

One point that needs to be stressed relates to the applicability of the Financial Health Spectrograph. The Spectrograph illustrates an

ideal distribution of assets, but everyone’s financial circumstances are different. Because of this, it is recommended that you consult with a licensed financial professional trained on the Spectrograph to determine the timing of when the shift between pre-retirement and post-retirement strategies may be best initiated. Another point to remember is that the Spectrograph offers no recommendations nor does it provide any solutions. It is meant as a diagnostic tool that illustrates where your assets lie in relation to the pre-retirement and post-retirement phases of life. One thing is certain, it is a one-of-a-kind tool that’s not only easy to use, it helps re-introduce investors to one of the fundamental elements of sound financial planning. ■

## How FHRI Works



Bob Lotter  
Founder, FHRI

Financial Health Research Institute helps educate you about your finances with unbiased resources, including informative booklets, MyAdvisor magazine, exciting online services, and more. Of course, it all starts with the Financial Health Spectrograph, the easy-to-use tool that measures the level of risk in your portfolio. But managing your investments requires more than just education. Even with FHRI’s tools and materials, you’ll still need the assistance of a licensed financial professional.

That’s why FHRI established a Membership Program for licensed financial professionals. Only those professionals who have met the Institute’s strict requirements are authorized to distribute FHRI’s materials. These requirements include a criminal background check, comprehensive credit review, and more. These professionals pay membership dues and other fees to support FHRI’s consumer education and research programs and, in exchange, have the opportunity to offer their services to consumers when requested.

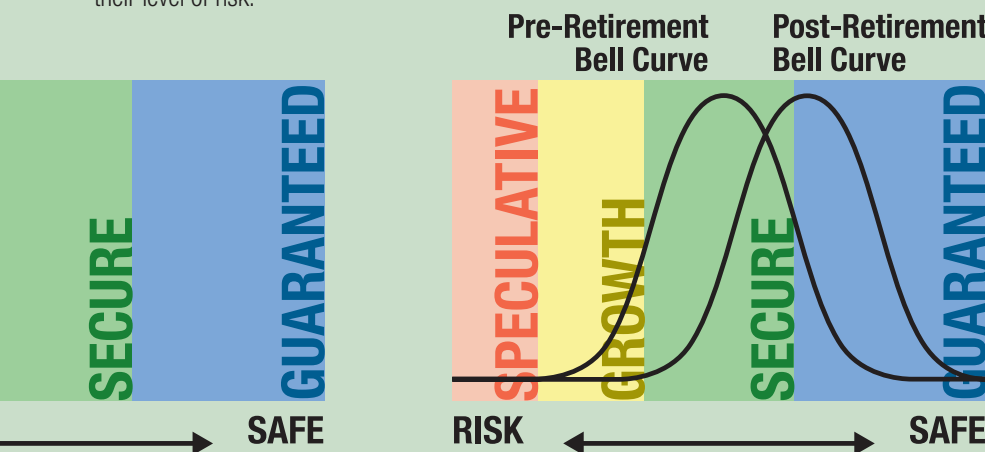
The process is simple: once you request a Spectrograph, an FHRI Member in your area will contact you to arrange a short meeting to gather the necessary information. After this meeting, if you would like further assistance from the FHRI Member it is completely up to you. There is never an obligation to do business with a Member and all of FHRI’s resources are FREE to the consumer and totally unbiased. The Institute NEVER earns any money from the sale of a financial product or service. I urge you to contact FHRI today to get your Spectrograph and expose the risk that may be lurking in your portfolio.

### Step #3:

By turning the Pyramid on its side, the investment areas found in the Investment Pyramid are now placed across a spectrum of risk. Instead of bottom to top, it is now right to left. Safety (lower returns) on the right, riskier (higher returns) on the left. Once the spectrum of risk was established, FHRI added the various types of assets to the spectrum...Plotting them according to their level of risk.

### Step #4:

There was still a need to make this spectrum time-sensitive, so FHRI developed a method to insert the variable of time through the use of bell curves. This spectrum required two bell curves, pre-retirement and post-retirement--designed to help investors see where they stand in relation to a normal distribution of assets for a particular age group. Turn the page to see the result!



\$

# Pre-Retirement Bell Curve

Based on the principles of the Investment Pyramid, the Financial Health Spectrograph delivers an unbiased assessment of your investments in relation to risk. Talk with an FHRI Member to create your Spectrograph.

## SPECULATIVE

**Metals & Gems, Art & Collectibles**  
Speculative investment that falls outside both the pre and post-retirement bell curve.

**Growth Stocks High-Yield Bonds**  
Growth investment that falls inside the pre-retirement bell curve, but outside the post-retirement bell curve.

## GROWTH

**Corporate Bonds**  
Secure investment that falls inside both the pre and post-retirement bell curves.

## SECURE

**Fixed Annuities**  
Guaranteed investment that falls inside both the pre and post-retirement bell curves.

# Post-Retirement Bell Curve

**Certificates of Deposit**  
Guaranteed investment that falls outside the pre-retirement bell curve, but inside the post-retirement bell curve.

## GUARANTEED

0 1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20



Metals & Collectibles Options & Futures Commodities Partnerships & Venture Capital Growth Stocks High-Yield Bonds Growth Mutual Funds Variable Life Investment & Annuities Real Estate Conservative Equities Corporate Bonds Government Bond Funds Real Estate Equity Indexed Annuities Fixed Annuities Cash Value Life Insurance Municipal Bonds Government Bonds & Notes Certificates of Deposit Money Market Savings & Checking

RISK

SAFE