LORING WARD

October 2014

PORTFOLIO PERSPECTIVES

Are You Getting What You Ordered?

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It's Friday night and you just got home after a long day at work. You kick off your shoes, grab the TV remote and open up the box of piping-hot pepperoni pizza your favorite pizza joint just delivered… But when you open the box, you find only about half of your pizza has pepperoni on it.

Believe it or not, something similar can happen to your investments. For example, your small cap fund could have lots of medium cap companies in it. This is called style drift and it can have a major impact on your retirement portfolio without you even realizing it.

Why does style drift matter?

You and your financial advisor determine the kind of investments you should have in your retirement portfolio based on important considerations such as your goals, numbers of years until retirement and comfort level with risk. If you're not getting what you "ordered" then you could end up with a different outcome. You may have a portfolio, for example, that is much riskier than you are comfortable with.

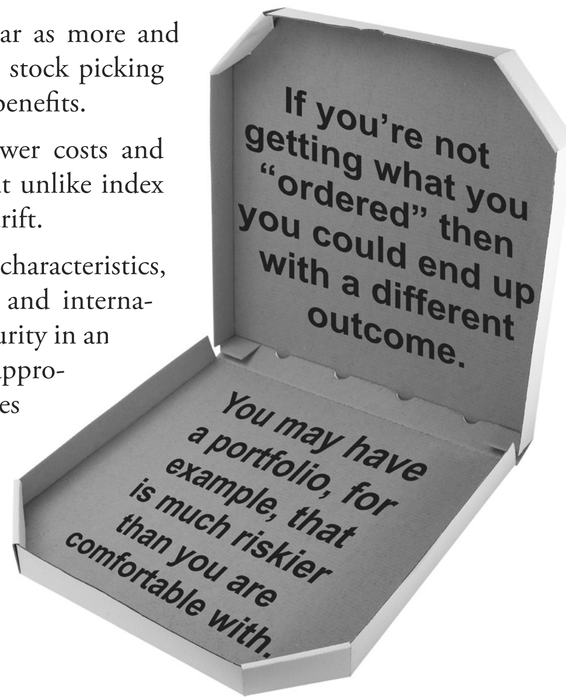
Style drift often occurs with actively managed mutual funds that chase return. But it can even affect index funds, despite the fact that they are specifically designed to mirror a particular index — such as Large Growth.

While index investing has become increasingly popular as more and more investors realize the benefits of this strategy over stock picking and market timing, style drift can erode some of these benefits.

Like index funds, asset class funds generally have lower costs and greater tax efficiency than their active counterparts, but unlike index funds, they are specifically designed to minimize style drift.

Asset classes are groups of securities with similar risk characteristics, such as small company stocks, large company stocks and international bonds. While index funds must include every security in an index, asset class fund managers can choose the most appropriate investments from the whole universe of securities in an asset class — not just the ones included in an index. And they can exclude IPOs, financially distressed and bankrupt companies and illiquid stocks that don't truly "fit" the asset class.

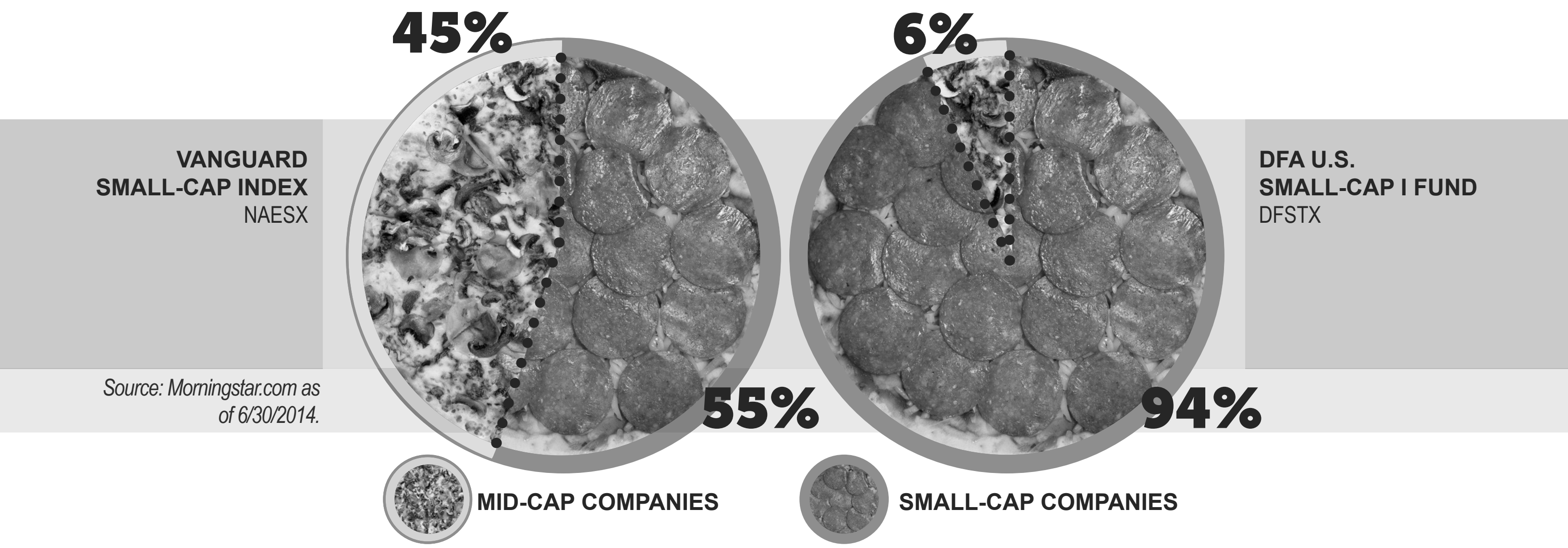
The result: less style drift for asset class funds.



Portfolio Perspectives

Look at the image below showing the differences between the Vanguard Small Cap Index portfolio and DFA US Small Cap portfolio. Both are designed to capture the returns of U.S. small cap companies.

The difference is the Vanguard portfolio tracks an index and the DFA portfolio replicates the asset class. As a result, Vanguard invested only 55% of its holdings in U.S. small cap companies as opposed to Dimensional's 94%.[1]



When you order a pepperoni pizza, you want lots of pepperoni, not 55% pepperoni and 45% stuff you don't want (maybe anchovies?). It's enough to ruin a Friday night and a retirement.

[1]The Morningstar methodology defines large-cap stocks as those that account for the top 70% of the capitalization of the Morningstar domestic stock universe; mid-cap stocks represent the next 20%; and small-cap stocks represent the balance. The Morningstar stock universe represents approximately 99% of the U.S. market for actively traded stocks.

Implementing asset class investment strategy cannot guarantee a gain or protect against a loss.

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