



Meet the Fuggers

“Divide your fortune into four equal parts: stocks, real estate, bonds and gold coins. Be prepared to lose on one of them most of the time. During inflation, you will lose on bonds and win on gold and real estate; during deflation, you lose on real estate and win on bonds, while your stocks will see you through both periods,

though in a mixed fashion. Whenever performance differences cause a major imbalance, rebalance your fortunes back to the four equal parts.”

– Jacob Fugger the Rich, 1459-1525

The fabulous Fugger family was a highly influential clan of German merchant princes. The family's initial wealth can be traced to Hans Fugger, an enterprising weaver who moved to Augsburg in 1367. His descendants built up the family fortune through trade and banking. None was more prominent than Jacob Fugger II, who was also known as Jacob the Rich. Through clever exploitation of a virtual monopoly in the mining and trading of silver, copper, and mercury, Jacob the Rich built an extensive network of real estate, merchant fleets and palaces throughout Europe. Jacob bought and sold politicians of the time, established sovereign rights over the family lands, and even coined his own currency. Thanks in large part to Jacob, the Fuggers became the richest family in Europe and were renowned as generous patrons of the arts and learning.

As the above quote illustrates, Jacob Fugger could also be considered the father of modern asset allocation. He clearly recognized the uncertainty of economic trends and the importance of diversification as a means of building and preserving wealth. To our knowledge, he was also the earliest to articulate the importance of strategic asset allocation and periodic portfolio rebalancing as bedrock principles of wealth management.

Jacob Fugger's strategic allocation was the essence of simplicity: He divided his fortune into four equal parts, with two of the four parts being in financial assets (stocks and bonds) and two being in real assets (gold and real estate). His focus on monitoring performance differences and periodically rebalancing his fortune obviously served him

well and has been a model for other wealth managers for generations.

Not all of the Fuggers fared as well as Jacob. Under Raimund Fugger and Anton Fugger, the family reached the limit of its power and its fortune in the 16th century when it financed the wars of the Hapsburg empire. Contrary to the principles of good asset allocation, the family ended up with too many of its eggs in the Hapsburg basket. Its subsequent decline paralleled that of the Hapsburgs. Sadly, little is left of the once fabulous wealth.

Common Sense, Uncommon Discipline

Can modern investors learn anything from Jacob Fugger? To be sure, his approach of dividing his assets into different categories would appear to be nothing more than common sense. And the old saying “don't put all your eggs in one basket” must surely predate Jacob the Rich.

But if his approach was rooted in common sense, it also required uncommon discipline to implement. His advice to “be prepared to lose on one of them most of the time” indicated a rather steely emotional makeup that many investors would be hard pressed to imitate. And his advice to rebalance the portfolio “whenever performance differences cause a major imbalance” is obviously much easier said than done. That's because it involves selling the asset class that has done well recently and putting money back into the asset class that has underperformed.

Most financial advisors will testify that it is emotionally very difficult for investors to follow that approach. A look at recent data on Canadian mutual fund flows will back that up. As we show in Table 1, foreign and U.S. equities were the most



Canadian Fund Flows and Subsequent Performance

Fund type	2000*** Total Sales	5-Yr Return*	2005** Total Sales	5-Yr Return
Income	-13%	6.9%	79%	?
Balanced	6%	2.8%	45%	?
Canadian Equity	16%	4.5%	-5%	?
Foreign Equity	73%	-4.7%	-13%	?
U.S. Equity	18%	-6.7%	-6%	?

*Source: Morningstar Averages; Jun. 00 - Jun. 05
 ** Source: IFIC, Jan. 1, 2005 to June 30, 2005
 *** Source: IFIC, Calendar Year 2000

Table 1: The most popular fund categories in 2000 subsequently experienced disappointing returns. Does the current popularity of income funds bode well for future returns?

popular fund categories in 2000, which followed years of red-hot global equity markets. Both categories experienced negative returns over the next five years. In contrast, the least popular fund categories in 2000 were income, balanced and Canadian equities. Those categories registered positive returns over the next five years. And, in the first half of 2005, the income and balanced categories dominated net sales.

In other words, instead of taking money away from the top-performing asset and adding money to the lagging asset, investors as a group have tended to do the exact opposite. That is why Jacob the Rich's rebalancing approach requires uncommon discipline – because it requires going against the crowd and resisting the very natural impulse to chase performance.

The Peril of Chasing Performance

Data from the Investment Funds Institute of Canada (IFIC) and Morningstar Canada also make clear that chasing performance has not benefited investors. Table 2 shows net flows of money by mutual fund category from 1998 to 2004 and corresponding performance on an annual basis. The conclusions from this data are striking:

- The best-performing fund category in any given year never followed a year when that fund category had the highest net flow of new money.
- Investors who chose to invest each year in the least popular fund category from the previous year earned a cumulative positive return of 20%.

- Investors who chose to invest each year in the most popular fund category from the previous year would have experienced a cumulative loss of 11%.

Is this pattern simply a fluke of the last few years? To test that, we looked at data on the total return of Canadian bonds, Canadian stocks, and world stocks over the past 25 years and asked a simple question: What would the returns have been of a "Chasing Performance" portfolio that each quarter put all of its assets into the asset class that had posted the best performance over the previous five years?

As shown in Chart 1, \$10,000 invested in that strategy at the beginning of 1980 would have grown to \$71,000 by the end of 2004. That assumes no taxes and no transaction costs for moving the money from one asset class to the other. The first assumption might make sense for RSP investors, but the second assumption is clearly a generous one in terms of making the strategy look as good as possible.

Although the Chasing Performance strategy did make significant returns in a period that has generally been favourable for financial assets, it suffers by comparison to simple buy-and-hold strategies. For example, a buy-and-hold strategy that matched Canada's equity market would have seen \$10,000 grow to \$103,000 by the end of 2004. Canadian bonds and world equities would have done far better, with the initial \$10,000 growing to \$169,000 and \$182,000 respectively, over the same period.

Does Chasing the Hot Asset Class Pay Off?

	1998	1999	2000	2001	2002	2003	2004	2005*
Income Performance	18.5	0.0	15.3	6.0	2.7	11.2	9.9	3.3
Income Fund Flow	17.7	22.0	7.0	-11.0	21.3	41.1	145.9	79.0
Balanced Performance	18.8	0.7	6.2	-1.8	-6.8	11.1	7.2	3.5
Balanced Fund Flow	21.4	24.7	14.0	4.9	17.7	21.7	17.8	45.1
Canadian Performance	26.1	-6.9	12.0	-2.0	-10.7	21.7	12.0	5.2
Canadian Fund Flow	37.0	23.3	-1.7	15.7	15.2	6.4	-31.5	-4.8
Foreign Performance	25.6	7.5	-4.0	-10.8	-20.7	11.7	5.6	1.2
Foreign Fund Flow	18.5	19.7	60.2	73.7	26.7	11.0	-37.5	-13.5
US Equity Performance	38.5	13.8	-1.2	-8.9	-23.3	6.2	1.6	0.6
US Equity Fund Flow	5.4	10.3	20.5	16.6	19.0	19.8	5.4	-5.8

* June 30, 2005
 Source: IFIC, Morningstar

Table 2: This table shows the annual performance for a fund category along with that category's sales, expressed as a percentage of total industry net sales for that year. Among other things, it shows that the category with the most sales in any one year was never the best performer in the following year.

We have obtained similar results over even longer historical periods, leading us to conclude that the Chasing Performance strategy has frequently been a losing strategy due to its propensity to “buy high and sell low.” It stands to reason, of course, that it is more likely that an asset class that has done extremely well for five years has a better chance of being overvalued and excessively popular than one that has recently registered disappointing performance.

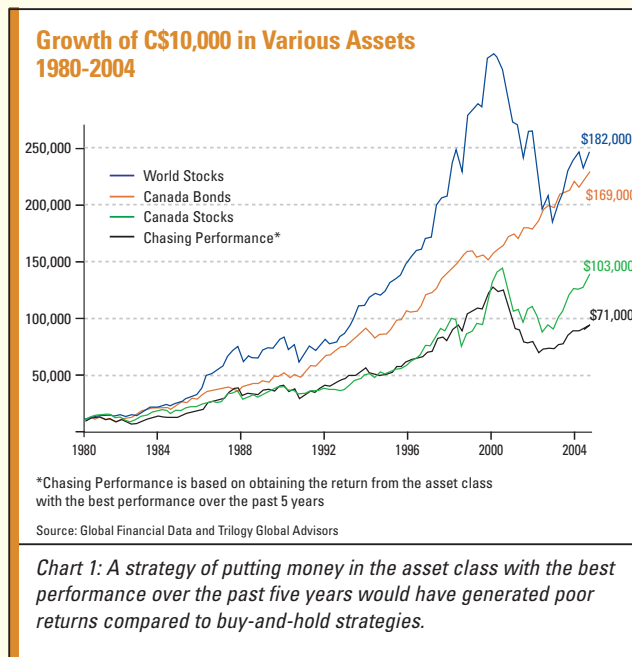
How Often to Rebalance?

Human nature may not have changed much since the time of Jacob the Rich, but modern computing technology and databases have made it much easier to analyze the pros and cons of various approaches to portfolio rebalancing. A leading analyst of the Fuggerite school, Dr. William Bernstein, has written extensively on what he calls “the rebalancing bonus.” His work can be found at www.efficientfrontier.com.

Dr. Bernstein has run the numbers on numerous approaches to portfolio rebalancing, including periodic monthly, quarterly, and annual rebalancing. He has also examined what he calls “threshold rebalancing,” which corresponds exactly to Jacob Fugger’s notion of rebalancing “when performance differences cause major imbalances.” Dr. Bernstein’s conclusions about periodic rebalancing were somewhat ambiguous. While all types of periodic rebalancing seemed to add value across many markets and time periods, there was no definitive conclusion about whether monthly, quarterly or annual rebalancing worked the best.

Interestingly, the evidence that Dr. Bernstein looked at suggested that Fugger’s concept of “threshold rebalancing” – i.e., rebalancing portfolios only after market movements put them out of kilter – was generally not as effective as simple periodic rebalancing, although it was better than not rebalancing.

We would conclude that, for most individuals who do not wish to hassle with monthly or quarterly portfolio rebalancing, annual rebalancing is probably quite sufficient. And to the extent that the very idea of rebalancing requires some kind of asset allocation target – like Fugger’s advice to “divide your fortune into four equal parts” – an annual exercise of portfolio rebalancing is likely to serve most investors well.



What investors don’t need to worry about asset allocation, diversification, or portfolio rebalancing? The founder of modern portfolio theory, Harry Markowitz, identified one such group: clairvoyants.

For the rest of us, it may be some small comfort that even Jacob Fugger the Rich did not belong to that select group, but still managed to achieve a measure of financial success.

Have you rebalanced your portfolio lately?

Enjoy the rest of your summer.

William Sterling

William Sterling
Chief Investment Officer
Trilogy Advisors, LLC