THE EFFICIENT FRONTIER REVISITED

GUGGENHEIM INVESTMENTS

The efficient frontier represents those portfolios that are considered the most efficient—that is, have the greatest return for a given level of risk.

Investors should generally seek the greatest return for a given level of risk. This concept, known as the efficient frontier, was first defined in 1952 by Harry Markowitz in the Nobel Prize-winning research that launched Modern Portfolio Theory.

The efficient frontier plots all optimal portfolios in a given time period based on two measures:

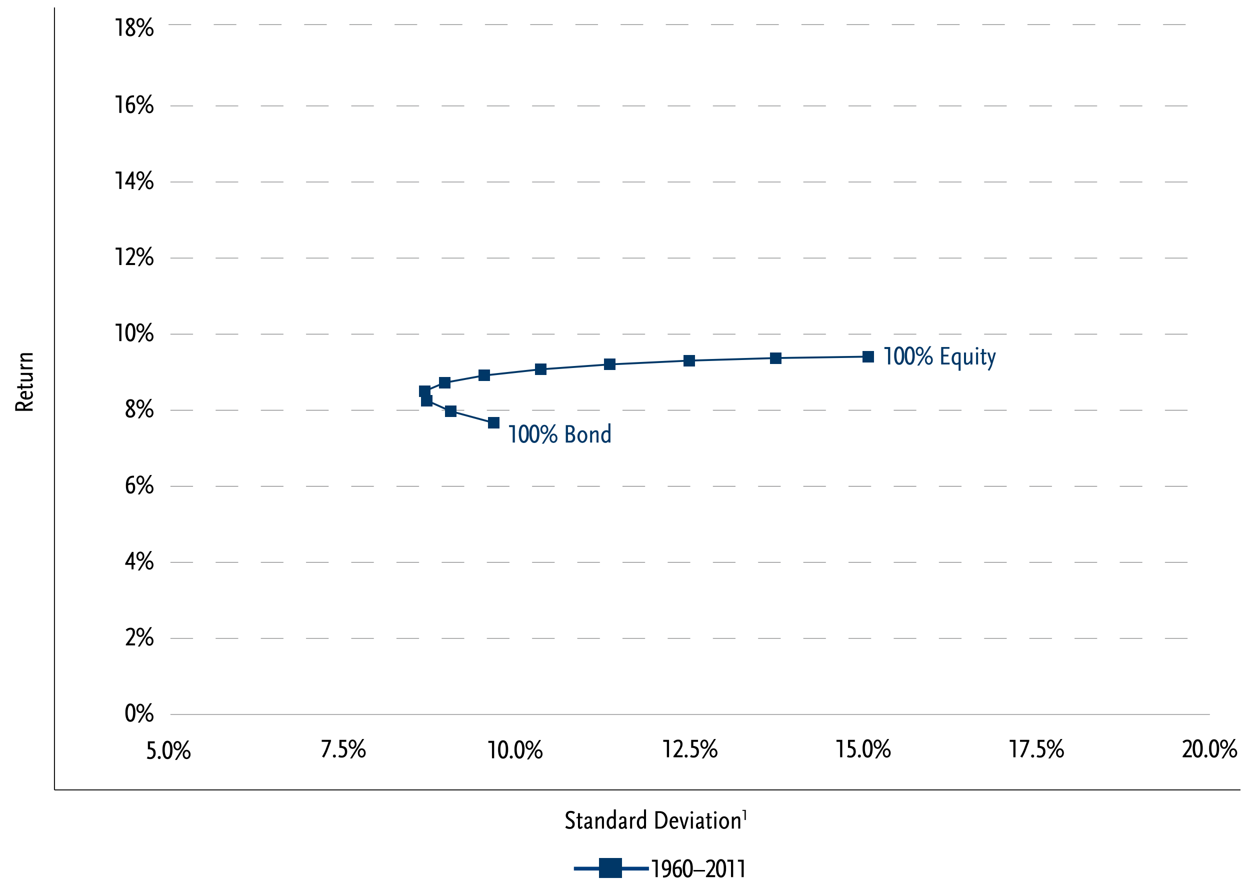
- Mean return
- Standard deviation (a measurement of risk)

The resulting curve is reflective of the correlations (a statistical measure of how two securities move in relation to each other) of the two asset classes.

Portfolios near the bottom left of the chart have relatively low risk and returns. Those near the upper right offer higher returns, but at a higher risk. The classic efficient frontier is shaped like a fishhook. It begins at the left tail with a 100% fixed-income investment. Equities are added in 10% increments until you reach the right tail, which represents a 100% equity portfolio.

The Risk/Return Ratio

As investors take on more risk in their portfolios, they expect their returns to go up. Investors can manage their risk tolerance through asset allocation and by selecting investments that meet their risk/return expectations.[2]



[1] Standard Deviation: A statistical measure of the historical volatility of an investment, usually computed using 36 monthly returns. More generally, a measure of the extent to which numbers are spread around their average. The higher the number, the more volatility is to be expected. [2] No investment strategy can guarantee returns in a declining market.

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THE INEFFICIENT FRONTIER?

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This image shows the efficient frontier by decade since 1960.

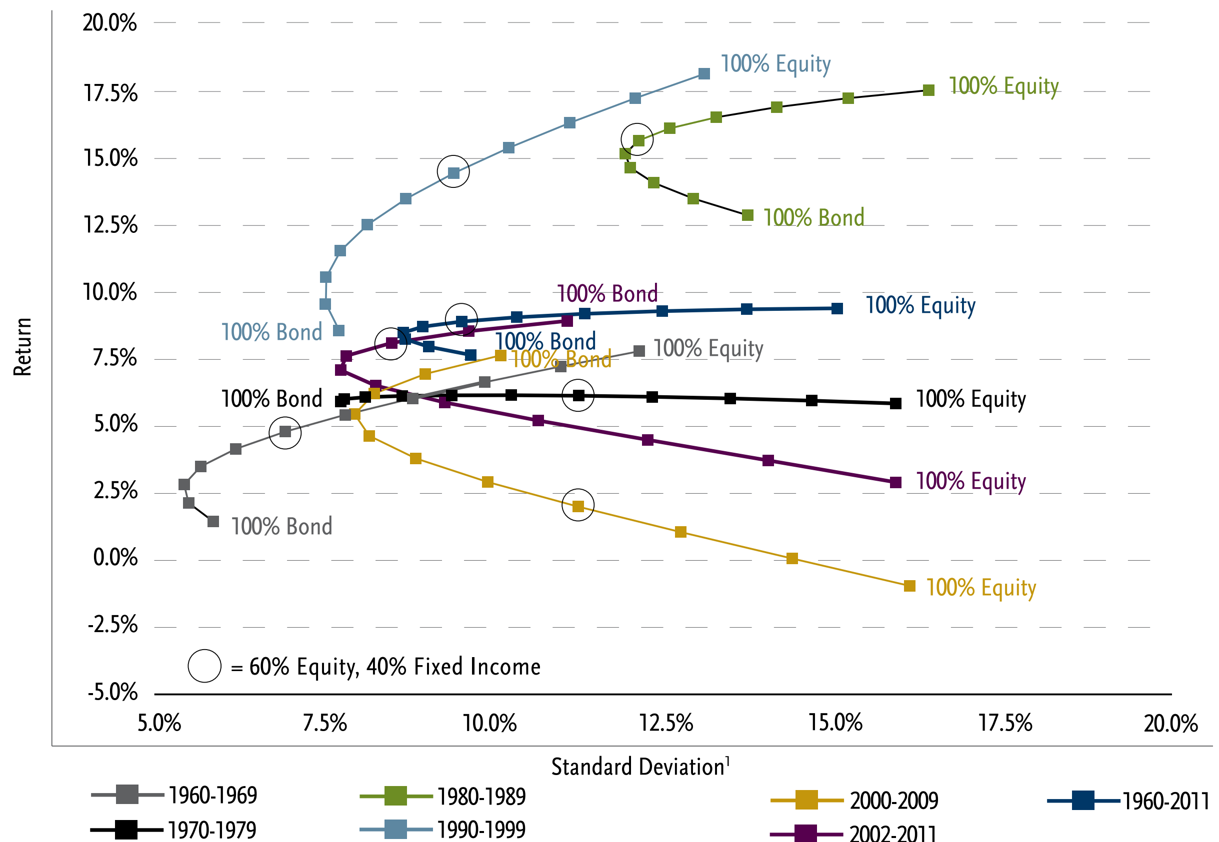
The dark blue fishhook on the chart indicates the historical average efficient frontier for the entire period. With each decade, the shape of the hook shifts and moves, depending on market conditions.

Investors expect their returns to go up as they take on more risk. However, the risk/return ratio, like the efficient frontier itself, changes along with market cycles.

In a strong market such as in the 1990s, you may be handsomely rewarded for taking on more risk.

In a weak market such as in the 1970s, you may only reap minimal returns when taking on more risk.

In the efficient frontier for 2000–2009 as well as for the most recent 10 years, the fishhook is actually inverted—indicating more risk for no additional returns, or for negative returns.



A static portfolio may not be right for changing market conditions. Call your financial professional today to re-evaluate your portfolio for today's markets—and ensure that it still meets your risk/return expectations.

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