When Diversification Fails?

Very little in finance can be taken for granted. One notable exception is portfolio diversification, a theory that has, on the whole, withstood the test of time. Diversification can be used to reduce overall portfolio risk by combining a variety of assets, or to boost returns in a fixed-risk portfolio. However, this bedrock of financial theory has been severely tested over the last five years.

During this period, almost every multi-asset portfolio lagged a 60/40 portfolio which was allocated to large capitalization, developed market stocks and sovereign bonds. The more diverse the portfolio, the worse it performed. According to a study published by First Quadrant[1], such a portfolio generated 10.24% return for the 3 year period ending October 2015. Replacing the equity component of the 60/40 portfolio with the MSCI All Country World Index, which includes emerging markets, reduced the returns to 7.47%. Adopting a diversified, balanced portfolio consisting of emerging market stocks, small-caps, REITS, inflation-indexed bonds and commodities, diminished returns to 4.64% -- a 5.60% hit, attributable to diversification! Over a five year horizon the numbers were comparable, with the 60/40 portfolio generating 7.62%. Adding an emerging market exposure produced 6.68%, and the diversified, balanced portfolio severely lagged at 4.61%. Clearly, the least diversified portfolio, with 90% of the risk attributable to the equity exposure, performed the best.

This briefing does not attempt to explain the reasons behind the failure of diversification. Rather, it demonstrates the limited extent of market breadth and the considerable impact on performance. For investors who didn’t invest exclusively in developed market stocks and sovereign bonds over the last five years, performance suffered tremendously. They had to thread the needle through a very narrow opportunity set in order to show solid performance.

Threading the Needle in Asset Selection

As illustrated in the preceding examples, the limited scope of asset class performance had a profound impact on portfolio returns. To understand how selective investors were, requires us to delve deeper.

If we had constructed the 60/40 portfolio using only the S&P500 and Treasuries instead of the developed market counterpart, the annualized 5 year return would have been 11.69%. Such a simple, even less diversified portfolio, would have outperformed by 407 basis points annually! Obviously, over the last 5 years, proponents of diversification paid a hefty price. We had to make do with a 4.61% return versus 11.69% for the US centric 60/40 counterpart. This amounted to a 7.08% performance penalty.

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Impact on Valuation

The dominance of US based, large capitalization equities was not entirely due to their superior earning or growth potential. Periods of heightened uncertainty result in drastic changes in risk aversion [2], so asset classes with a real or perceived sense of safety dominate. The period from the 2008 financial crash until early 2016 is one such example. During such periods, performance comes almost entirely from multiple expansion, as investors bid up the price of supposedly "safe" assets. The FTSE/Russell chart below clearly demonstrates this fact[3].

Regional Valuation Comparisons (12M forward)

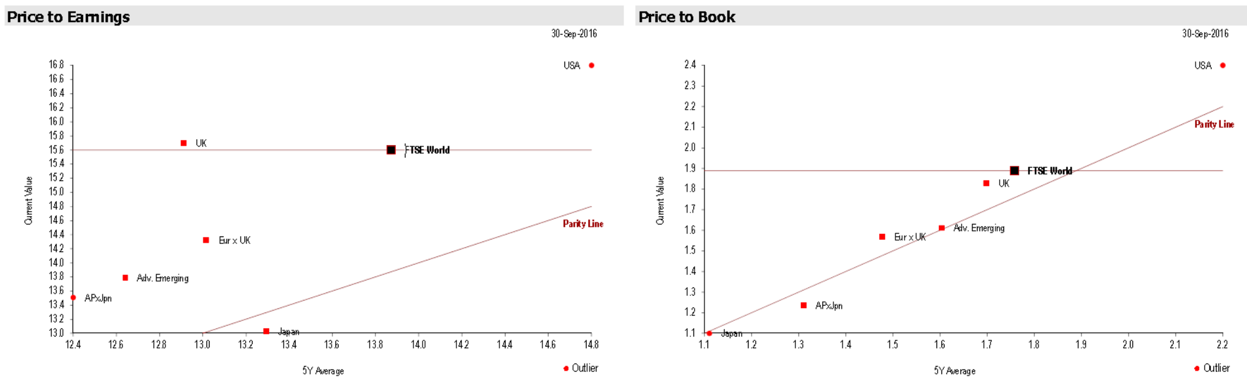

Exhibit 1 – Comparative Global Market Valuations (Source: FTSE/Russell)

Alternatively, we can observe this valuation discrepancy in P/E multiples assigned to the US, Developed and Emerging markets.

Fund	12M P/E
S&P 500 Index	19.76
MSCI EAFE	15.89
Core MSCI Emerging Markets	11.93

Table 1. Comparative Valuation, Source IShares

Due to this valuation adjustment, the US has become one of the most expensive markets in the world. It would be easy to jump to the conclusion that US assets are overvalued and due for a reset. However, this would be too simplistic. Today, risk is higher in the US based 60/40 portfolio, but valuation differences is only one aspect of asset class leadership. To quote Newton, "Markets can remain over valued for a lot longer than one can remain solvent."

Is Diversification Likely to Work Again?

Over a longer time horizon, multiple expansion becomes less of a factor, and returns are driven by differences in realized economic performance and valuation [4]. In other words, the more a given asset is bid up, the less safe it becomes for those holding it. However, timing when markets might recognize the overvaluation of one asset vs. the enhanced fundamentals of another is an impossible task for mere mortals. This fundamental force combined with the inability to guess the timing of such outperformance justifies diversification as a basis for portfolio construction. We simply do not know when one of our holdings is going to shine or flop, so we diversify.

Most financial theories, including one as time tested as diversification, is based on human behavior. As it is well-nigh impossible to predict human behavior, patience is key to investing success. To quote Warren Buffet: “Success in investing doesn’t correlate with IQ…. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing.”

Until diversification once again reigns, I wish you all the will to persevere.

Kindest regards,

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References

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