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Portfolio Perspectives

Diversification Didn't Work Last Year, or So It Seems

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I heard someone say diversification didn't work last year and I can understand how they came to that conclusion. The U.S. stock market was one of the top performing asset classes earning 13.69% in 2014, second only to the U.S. Real Estate asset class which earned 32% for the year.[1] Compare those returns to those of your globally diversified portfolio (with returns much lower than the top asset classes) and you may come to the conclusion that diversification didn't work as well.

But before we decide diversification doesn't work, let's dig a little deeper to understand why anyone would diversify their portfolio in the first place. This notion of diversification and its benefits have been known for millennia. The concept is mentioned in ancient text such as the Talmud[2], the Bible[3] and even one of Shakespeare's plays.[4]

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The work of Harry Markowitz — Nobel Laureate, Loring Ward Investment Committee Member, and "Father of Modern Portfolio Theory" — revolutionized investing and showed that it was possible to select a collection of investments that has collectively lower risk than an individual asset. This is possible because different investments often change in value in opposite ways. For example, to the extent prices in the stock market move differently from prices in the bond market, a portfolio of both stocks and bonds can, in theory, face lower overall risk than either individually.

[1] U.S. Stock Market represented by the S&P 500 Index; U.S. Real Estate represented by the Dow Jones U.S. Select REIT Index.

[2] Duchin, R., Levy, H., 2009. Markowitz versus the Talmudic portfolio diversification strategies. Journal of Portfolio Management 35, 71–74.

[3] Ecclesiastes 11:2

[4] Shakespeare, William. The Merchant of Venice, Act I, Scene I.

Asset Class Returns 2000-2014

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2000 - 2014 Annualized Returns
US REIT 31.04%	US REIT 12.35%	US Short Term Bond 6.09%	Emerging Markets Value 62.26%	US REIT 33.16%	Emerging Markets Value 32.95%	US REIT 35.97%	Emerging Markets Value 42.20%	Global Short Term Bond 6.59%	Emerging Markets Value 79.11%	US REIT 28.07%	US REIT 9.37%	Intl Small Cap 20.00%	US Small Cap 38.82%	US REIT 32.00%	US REIT 12.74%
Global Short Term Bond 8.28%	US Short Term Bond 8.71%	Global Short Term Bond 5.10%	Intl Small Cap 61.35%	Intl Small Cap 30.78%	Intl Small Cap 26.19%	Emerging Markets Value 31.96%	US Short Term Bond 6.87%	US Short Term Bond 4.69%	Intl Small Cap 46.79%	US Small Cap 26.86%	Global Short Term Bond 2.31%	Intl Large Value 17.69%	US Large Value 32.53%	US Large 13.69%	Emerging Markets Value 8.08%
US Short Term Bond 8.08%	Global Short Term Bond 6.44%	US REIT 3.58%	US Small Cap 47.25%	Emerging Markets Value 30.66%	US REIT 13.82%	Intl Large Value 30.38%	Global Short Term Bond 6.30%	Cash 1.60%	Intl Large Value 34.23%	Intl Small Cap 22.04%	US Large 2.11%	US Large Value 17.51%	US Large 32.39%	US Large Value 13.45%	US Small Cap 7.38%
US Large Value 7.02%	Cash 3.83%	Cash 1.65%	Intl Large Value 45.30%	Intl Large Value 24.33%	Intl Large Value 13.80%	US Large Value 22.25%	Intl Large Value 5.96%	65/35 Mix -24.31%	US REIT 28.46%	Emerging Markets Value 18.41%	US Short Term Bond 1.56%	US REIT 17.12%	Intl Small Cap 29.30%	US Small Cap 4.89%	Intl Small Cap 7.18%
Cash 5.89%	US Small Cap 2.49%	Emerging Markets Value -4.54%	US REIT 36.18%	US Small Cap 18.32%	65/35 Mix 8.77%	Intl Small Cap 19.31%	US Large 5.49%	US Small Cap -33.79%	US Small Cap 27.17%	US Large Value 15.51%	US Large Value 0.39%	US Small Cap 16.35%	Intl Large Value 22.95%	65/35 Mix 4.48%	US Large Value 6.62%
65/35 Mix 0.75%	Emerging Markets Value 1.48%	65/35 Mix -7.80%	US Large Value 30.03%	US Large Value 16.49%	US Large Value 7.03%	US Small Cap 18.37%	65/35 Mix 5.29%	US Large Value -36.85%	US Large 26.46%	US Large 15.06%	Cash 0.04%	US Large 16.00%	65/35 Mix 17.14%	Global Short Term Bond 1.90%	65/35 Mix 6.07%
US Small Cap -3.03%	65/35 Mix -2.59%	Intl Small Cap -7.82%	US Large 28.69%	65/35 Mix 14.16%	US Large 4.91%	65/35 Mix 16.62%	Cash 4.66%	US Large -37.00%	65/35 Mix 22.67%	65/35 Mix 11.10%	65/35 Mix -2.67%	Emerging Markets Value 15.87%	US REIT 1.22%	US Short Term Bond 0.78%	US Large 4.24%
Intl Large Value -3.14%	US Large Value -5.59%	US Large Value -15.53%	65/35 Mix 27.68%	US Large 10.88%	US Small Cap 4.55%	US Large 15.80%	Intl Small Cap 1.45%	US REIT -39.20%	US Large Value 19.69%	Intl Large Value 3.25%	US Small Cap -4.18%	65/35 Mix 11.76%	US Short Term Bond 0.71%	Cash 0.02%	Intl Large Value 3.82%
Intl Small Cap -7.56%	US Large -11.89%	Intl Large Value -15.91%	US Short Term Bond 2.76%	Global Short Term Bond 2.66%	Global Short Term Bond 3.08%	Cash 4.80%	US Large Value -0.17%	Intl Large Value -44.09%	US Short Term Bond 3.83%	US Short Term Bond 2.82%	Intl Large Value -12.17%	Global Short Term Bond 2.10%	Global Short Term Bond 0.62%	Emerging Markets Value -4.08%	Global Short Term Bond 3.69%
US Large -9.10%	Intl Small Cap -12.51%	US Small Cap -20.48%	Global Short Term Bond 1.94%	Cash 1.20%	Cash 2.98%	US Short Term Bond 4.25%	US Small Cap -1.56%	Intl Small Cap -47.01%	Global Short Term Bond 2.29%	Global Short Term Bond 1.99%	Intl Small Cap -15.94%	US Short Term Bond 1.48%	Cash 0.02%	Intl Small Cap -4.95%	US Short Term Bond 3.67%
Emerging Markets Value -31.47%	Intl Large Value -18.52%	US Large -22.10%	Cash 1.02%	US Short Term Bond 1.20%	US Short Term Bond 1.75%	Global Short Term Bond 4.09%	US REIT -17.56%	Emerging Markets Value -50.27%	Cash 0.10%	Cash 0.12%	Emerging Markets Value -17.86%	Cash 0.06%	Emerging Markets Value -5.11%	Intl Large Value -5.39%	Cash 1.85%

Source: Morningstar Direct

Past performance is not a guarantee or a predictor of future results of either the indices or any particular investment. The information provided is not advice and does not take into account you/your client's personal circumstances. Before making any decision or recommendation you should consider all relevant personal circumstances and options. International markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. The risks associated with investing in stocks and overweighting small company and value stocks potentially include increased volatility (up and down movement in the value of your assets) and loss of principal. Fixed income securities are subject to interest rate risk because the prices of fixed income securities tend to move in the opposite direction of interest rates. Emerging markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. Real estate securities funds are subject to changes in economic conditions, credit risk and interest rate fluctuations All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

We can see this risk reduction illustrated in the chart above, which shows the returns of several major asset classes and a diversified portfolio of these asset classes for the last 15 years. Looking at the chart it probably doesn't take you long to realize that the colors appear to be randomly spread across the chart. It's almost like someone took a bag of Skittles candies and dumped them out on a table. Their placement is completely random.

As you stare at the chart a bit longer you may start to notice that the riskier asset classes seem to tradeoff between residing somewhere at the top and somewhere at the bottom of the chart. You probably also noticed that the diversified portfolio mix is usually positioned somewhere in the middle, never reaching the top of the chart but never sitting on the bottom either.

Diversification is the reason the portfolio mix is never the worst performer. It may keep your portfolio from being the top performer, but diversification helps ensure your portfolio isn't at the bottom of the chart, something that can put a monkey wrench in anyone's retirement. It also helps reduce the volatility of your portfolio, which becomes critical when you are in retirement and pulling money from your portfolio.

If you have a perfect knowledge of which asset class will be at the top each year or know someone that does, you don't need diversification. For the rest of us, diversification is a good strategy.

Diversification neither assures a profit nor guarantees against loss in a declining market.
Past performance does not guarantee future results