Commentary

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Diversification: The Perils of Nearsightedness

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Much of the time, adhering to the philosophy of diversification is not terribly difficult—some asset classes move up, others move down, and diversified investors collect a compelling return while remaining grateful that they had not placed all of their eggs in one basket. Occasionally, though, the market tests our resolve.

Over the past few years, U.S. equities have performed extraordinarily well. With the U.S. economy recovering much more quickly than most of its developed market peers, corporate earnings and stock valuations have soared. As such, U.S. stocks have dominated other asset classes in the capital markets, leading many investors to regret allocating to diversifying assets such as international equities, fixed income, and real assets.

When a single asset class provides superior returns for several periods in a row, investors are understandably tempted to stray from their commitment to diversification. The temptation becomes even stronger when the dominant asset class is one such as U.S. equity, which receives the most attention in popular media, and which many investors follow on a daily basis. Periods of relatively concentrated U.S. equity outperformance, like the past two calendar years, lead many investors to wonder whether they still need diversifying assets in their portfolios.

In Defense of Diversification

Despite the superior performance of U.S. equities (the various flavors of which are highlighted on the left side of Exhibit 1), we need not look far back in history to witness the dangers of concentrating portfolio holdings in domestic stocks. Calendar year 2008 provides the most salient example, as shown in Exhibit 2. Investors that were allocated heavily (or exclusively) to equities suffered tremendous losses as the capital markets navigated the global financial crisis. As of early 2009, some equity portfolios had lost half of their peak values that were attained just a year and a half earlier.

Exhibit 1: Sometimes Equities Lead the Pack…

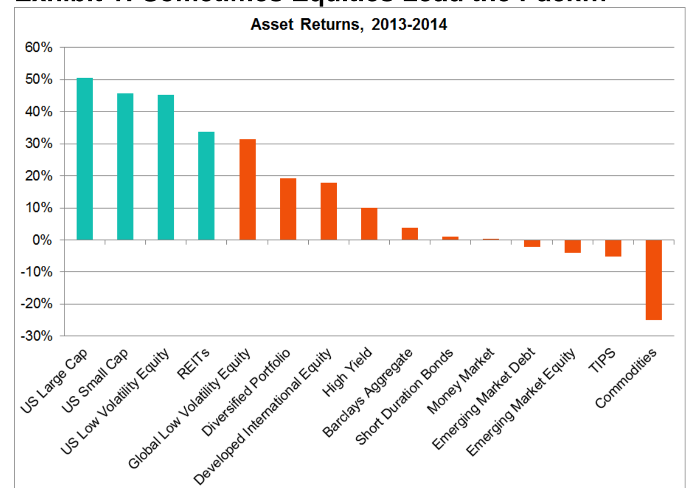
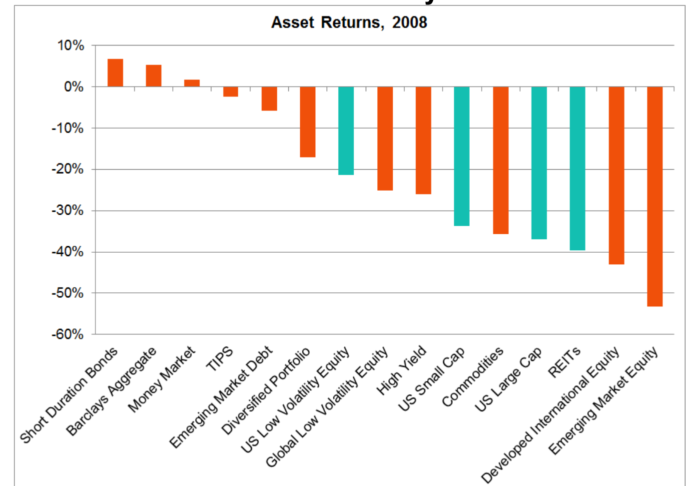


Exhibit 2: …And Sometimes They Don't



The dangers of concentration will come as little surprise to those who experienced the 2008 global financial crisis. Many lesser-known historical examples tell the same story: concentrating holdings in a single risky asset, regardless of the asset, exposes investors to unnecessary amounts of volatility and potential for loss.

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The "diversified portfolio,[1]" on the other hand, lies somewhere in the middle of return rankings over both 2008 and the 2013-to-2014 period, as well as in every individual year displayed in Exhibit 3. While the long-term return expectation for a diversified portfolio is certainly compelling, the crucial advantage offered by diversification is its risk reduction: the diversified portfolio participated meaningfully in the 2013-to-2014 U.S. stock rally, while materially reducing drawdowns in 2008.

We acknowledge (and emphasize) that investing in capital markets necessarily involves risk. However, we firmly believe that, whatever amount of risk an investor chooses to take, that investor should receive as much expected return as possible in exchange for assuming that degree of risk. The essence of portfolio efficiency is *refusing to take risks that one is not compensated for taking*. In our view, diversification offers investors the most reward for a given level of risk by minimizing uncompensated volatility.

Exhibit 3: Diversified Portfolios Deliver More Consistent Results

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1	Emerging Market Equity 34.54%	REITs 36.73%	Emerging Market Equity 39.82%	Short Duration Bonds 6.66%	Emerging Market Equity 79.02%	REITs 28.09%	US Low Volatility Equity 14.78%	Emerging Market Equity 18.63%	US Small Cap 38.82%	REITs 30.43%
2	Commodities 21.36%	Emerging Market Equity 32.55%	Commodities 16.23%	Barclays Aggregate 5.24%	High Yield 58.1%	US Small Cap 26.85%	TIPS 13.56%	REITs 17.98%	US Large Cap 32.39%	US Low Volatility Equity 17.49%
3	Developed International Equity 14.02%	Developed International Equity 26.86%	TIPS 11.64%	Money Market 1.77%	Developed International Equity 32.46%	Emerging Market Equity 19.2%	Barclays Aggregate 7.84%	Developed International Equity 17.9%	US Low Volatility Equity 23.59%	US Large Cap 13.69%
4	REITs 12.43%	Global Low Volatility Equity 24.52%	Developed International Equity 11.63%	TIPS -2.35%	REITs 28.61%	Commodities 16.83%	REITs 7.75%	US Small Cap 16.35%	Developed International Equity 23.29%	Global Low Volatility Equity 11.61%
5	Global Low Volatility Equity 9.77%	US Low Volatility Equity 19.69%	Emerging Market Debt 10.46%	Emerging Market Debt -5.75%	US Small Cap 27.17%	High Yield 15.07%	Global Low Volatility Equity 6.02%	US Large Cap 16%	Global Low Volatility Equity 17.66%	Diversified Portfolio 6.59%
6	Emerging Market Debt 8.43%	US Small Cap 18.37%	Global Low Volatility Equity 7.61%	Diversified Portfolio -17.03%	US Large Cap 26.46%	US Large Cap 15.06%	High Yield 4.37%	High Yield 15.55%	Diversified Portfolio 11.75%	Barclays Aggregate 5.97%
7	Diversified Portfolio 5.38%	US Large Cap 15.79%	Diversified Portfolio 7.38%	US Low Volatility Equity -21.41%	Diversified Portfolio 21.44%	Global Low Volatility Equity 15.04%	Emerging Market Debt 3.69%	Emerging Market Debt 14.38%	High Yield 7.41%	US Small Cap 4.89%
8	US Large Cap 4.91%	Diversified Portfolio 11.53%	Short Duration Bonds 7.1%	Global Low Volatility Equity -25.13%	Emerging Market Debt 20.1%	US Low Volatility Equity 13.36%	Diversified Portfolio 3.06%	Diversified Portfolio 11.17%	REITs 2.46%	Emerging Market Debt 3.79%
9	US Small Cap 4.55%	High Yield 10.73%	Barclays Aggregate 6.97%	High Yield -26.11%	US Low Volatility Equity 19.22%	Emerging Market Debt 12.02%	US Large Cap 2.11%	Global Low Volatility Equity 10.83%	Short Duration Bonds 0.37%	TIPS 3.64%
10	Money Market 3%	Emerging Market Debt 10.38%	US Large Cap 5.49%	US Small Cap -33.79%	Commodities 18.91%	Diversified Portfolio 11.06%	Short Duration Bonds 1.56%	US Low Volatility Equity 10.3%	Money Market 0.05%	High Yield 2.51%
11	TIPS 2.84%	Money Market 4.8%	Money Market 4.78%	Commodities -35.65%	Global Low Volatility Equity 18.04%	Developed International Equity 8.21%	Money Market 0.07%	TIPS 6.98%	Barclays Aggregate -2.02%	Short Duration Bonds 0.64%
12	High Yield 2.76%	Barclays Aggregate 4.33%	High Yield 2.57%	US Large Cap -37%	TIPS 11.41%	Barclays Aggregate 6.54%	US Small Cap -4.18%	Barclays Aggregate 4.22%	Emerging Market Equity -2.27%	Money Market 0.03%
13	Barclays Aggregate 2.43%	Short Duration Bonds 4.12%	US Low Volatility Equity 0.58%	REITs -39.56%	Barclays Aggregate 5.93%	TIPS 6.31%	Developed International Equity -11.73%	Short Duration Bonds 0.51%	Emerging Market Debt -5.84%	Emerging Market Equity -1.82%
14	US Low Volatility Equity 2.2%	Commodities 2.07%	US Small Cap -1.57%	Developed International Equity -43.06%	Short Duration Bonds 1.41%	Short Duration Bonds 2.4%	Commodities -13.32%	Money Market 0.08%	TIPS -8.6%	Developed International Equity -4.48%
15	Short Duration Bonds 1.73%	TIPS 0.41%	REITs -16.4%	Emerging Market Equity -53.18%	Money Market 0.15%	Money Market 0.14%	Emerging Market Equity -18.17%	Commodities -1.06%	Commodities -9.52%	Commodities -17.01%

[1]The representative diversified portfolio consists of the following blend of investments: 29% S&P 500, 3% Russell 2000, 2% Emerging Market Equity, 9% MSCI EAFE, 7.5% Emerging Market Debt, 7.5% High Yield Bonds, 39.75% Barclays Aggregate, 2% TIPS, and 0.25% Money Market.

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Experiment

In this spirit, we embarked on an experiment intended to illustrate the properties of various styles of investing. We tracked the annual performance of several hypothetical investment strategies over 10 years, from 2005 to 2014. Our first strategy, dubbed the "Return Chaser," consists of allocating 100% of one's portfolio to the asset class that produced the highest return in the previous calendar year.

The second strategy, labeled "Concentrated Contrarian," invests 100% of its assets in the worst-performing asset class from the previous calendar year.

The final strategy, titled "Diversified Portfolio," follows the same strategic asset allocation as the diversified portfolio in the previous charts, and adheres to the same asset class weights regardless of short-term market dynamics. Exhibit 4 presents 10-year risk and return characteristics for the different strategies.

Exhibit 4 demonstrates the dangers associated with concentrated investing over the 2005-to-2014 period. During this 10-year span, the Diversified Portfolio dominates both concentrated strategies on measures of both return and risk. While realized returns will necessarily depend on the specific time period chosen, the most recent decade provides a salient example of the perils of risk concentration. Naturally, both the Return Chaser and Concentrated Contrarian portfolios exhibit higher year-to-year volatility due to their lack of diversification and balance.

The lackluster cumulative returns of the concentrated strategies show that risk does not go away as the time horizon expands—strategies that are unnecessarily volatile over one year are generally still unnecessarily volatile over ten years.

Importantly, the specific type of concentrated strategy is irrelevant: whether following the trend or fighting against it, both concentrated portfolios fail to deliver competitive risk-adjusted returns. If the Return Chaser can stomach 23% annual volatility, he or she is welcome to do so: but by pursuing that level of volatility with a balanced, diversified portfolio, this investor can achieve much higher returns than the Return Chaser strategy offers. The crucial distinction is that, in a truly diversified portfolio, all risk is *compensated risk*.

Conclusion

We hope that readers are not surprised by our conclusions. We at SEI have always held diversification to be a keystone of successful investing, and we continue to seek new ways in which to enhance the efficiency of our portfolios. The recent strong performance of the U.S. stock market has been a boon for investors, and we hope that this phenomenon continues. However, we know that nothing in the financial markets is certain, and we will not allow short-term historical performance to fool us into abandoning our philosophy of diversification. Regardless of an investor's level of risk tolerance, we are confident that diversification allows us to earn as much return as possible given the desired level of risk. Diversification ensures that investors are paid for every unit of risk that they take.

Exhibit 4*

	Return Chaser	**Concentrated Contrarian**	**Diversified Portfolio**
Annualized Return	-1.51%	1.34%	6.78%
Volatility	23.21%	30.64%	9.89%
Maximum Annual Drawdown	-53.18%	-39.56%	-17.03%

*Hypothetical samples prepared for analysis only and results shown are not meant to represent any particular portfolios.

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Glossary of Financial Terms

Volatility (Standard Deviation): Statistical measure of historical volatility. A statistical measure of the distance a quantity is likely to lie from its average value. It is applied to the annual rate of return of an investment, to measure the investment's volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment's return will be. A standard deviation of zero would mean an investment has a return rate that never varies.

Maximum Drawdown: A drawdown is the high-to-low decline during a specific record period of an investment. A drawdown is usually quoted as the percentage between the high and the low. A maximum drawdown is the most significant drawdown over the period.

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Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. Past performance does not guarantee future results Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

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