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For investors, asset diversification pays off if you do it right

Individual investors make bad decisions. That is the conclusion of a recent study, showing that 401(k) plan investors are increasingly tilting their accounts toward stocks although stock market valuations have risen significantly.

According to the study from Aon Hewitt, stocks now account for 67 percent of employees' new contributions to their employer-sponsored retirement plans. The study notes that this is the highest level of commitment to the stock market since March 2008, up from a low of 48 percent in February 2009. The market was relatively strong in March 2008 but deep into the throes of a bear market in February 2009. So investors tend to put more money into stocks when the market is high and less when the market is low. That's not the best recipe for success.

Indeed, a study by finance professors Brad Barber and Terrance Odean found that most individual investors hold underdiversified portfolios and "trade actively, speculatively and to their own detriment." The study showed that individual investors underperform the market by 1.5 percent annually.

There are numerous explanations for why investors engage in detrimental behaviors. Shortcomings in human nature, a lack of skill and malfeasance by advisers have all been fingered. There probably is some truth to all of them, but I think investors are tired of the old investment maxims of asset allocation, diversification and buy-and-hold. Most people don't believe, or are encouraged by the investment industry not to believe, that these approaches work. And you can't blame them.

During the 1990s, large-cap growth stocks, specifically those in the technology sector, outperformed all other market sectors and asset classes. Diversification into anything except technology stocks likely resulted in disappointing performance.

In 2002, when technology stocks imploded, they dragged virtually all other market segments down with them. Diversification within the stock market did not help prevent losses.

The crash of 2008 also was indiscriminate in its carnage. Stocks, REITs, commodities, even many bonds fell precipitously in value during this period. Again, when it was needed most, diversification was not much help.

VIEWPOINT
Mark Armbruster

Finally, in the stock market rebound of the past several years, U.S. stocks have outpaced effectively every other asset class. You would have earned higher returns being concentrated, rather than spreading your bets across many different asset classes.

So is the behavior of individual investors actually rational? Should we be concentrating our bets in one narrow slice of the market to improve our results? Should we be tactically shifting our portfolios to find the optimal position at every point in time?

No. Used correctly, diversification is a powerful tool that serves a dual purpose, hedging both short-term market corrections and long-term underperformance of a single asset class.

Let's start with protecting against short-term market crises. Both in 2002 and 2008, the stock market declined precipitously. Large-cap stocks, small-cap stocks, international stocks, REITs, emerging market stocks, even commodities either lost money or provided very anemic returns. In 2008, even many segments of the bond market lost 30 percent or more of their value.

Diversifying among these asset classes would not have provided much protection. The reason is that while these asset classes do offer diverse return characteristics during more stable market environments, they all rely on economic growth. This is a simplified view, since other factors, such as liquidity and sentiment, also play a role. However, more fundamentally, when economic growth dries up, economically exposed investments cannot continue to thrive.

The solution, then, to hedge the risk of major short-term corrections is to find investments that are countercyclical with economic growth. High-quality bonds, particularly Treasury bonds, are the answer. Many investors will not like that answer, because expected returns for bonds are quite low currently, but they offer one of the few protections against severe, sudden economic and stock market downturns. In 2002, when stocks declined 22 percent, high-quality bonds were up more than 10 percent. In 2008, stocks were down almost 37 percent, but bonds were up more than 5 percent. Thus, diversification does work if you implement it properly.

Diversification also is useful for hedging a more insidious type of risk: long-term underperformance. Short-term bear markets can be painful, but they are easy to recover from if you are patient. However, the long-term underperformance of a class of investments can be far more damaging.

Imagine being a Japanese investor in 1989. The local stock market, as measured by the Nikkei Index, had been making new highs for several years. The economy was growing by leaps and bounds. All your friends and neighbors were making a killing in the stock market. So you bought into stocks in late 1989.

Just then, the bottom fell out. Japanese stocks have been in a downward trend since. There have been short-term upcycles, but you would still be nowhere near recovering your money, even 25 years later. A similar event happened to those concentrated in technology stocks in this country in the late 1990s. The tech-heavy Nasdaq index still has not recovered its losses from 15 years ago.

If you were unfortunate enough to have invested this way, you could lose decades of earning power. However, this risk can largely be diversified away. By investing in several asset classes, including domestic stocks, international stocks, REITs and possibly others, you can minimize the risk of long-term damage. While Japanese stocks have languished, stocks in the United States, Europe and emerging markets have gone on to record highs. Technology has been in the doldrums for years, but oth-

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er industry sectors have flourished. Spreading your bets around makes a lot of sense to grow and protect long-term wealth.

Diversification may not be a silver bullet that prevents losses in every market environment, which is why its efficacy is often called into question. However, it can help prevent investment disasters, such as undue losses during market crashes, or a lost generation of long-term wealth creation. The old saying is that you get rich by being concentrated, but you stay rich by being diversified. There is some truth to that, but you get rich only if you are concentrated and lucky. Diversification is a surer bet to both wealth creation and preservation.

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