ROCHESTER BUSINESS JOURNAL
RBJ
WWW.RBJ.NET
NOVEMBER 30, 2018

True portfolio diversification involves multiple asset classes

ON INVESTING
Mark Armbruster

The diversification of an investment portfolio has been described as the one “free lunch” in the investment world. That is because holding a portfolio of assets with unique risk and return characteristics can result in higher long-term returns and a lower risk profile.

There have been studies that show you can achieve sufficient diversification in a portfolio with as few as 30 stock holdings. That may be true, but those 30 stocks need to be chosen very carefully. If most of the stocks are from the same industry, then the diversification benefits will be diminished.

For most investors, true diversification involves holding multiple asset classes, such as stocks, bonds, real estate, cash, and maybe some alternative assets such as commodities, currencies, derivatives, or catastrophe bonds. Within each of those categories, several diverse assets should be held.

For example, within stocks, a truly diversified portfolio would likely include commitments to large, mid, and small-capitalization stocks, international stocks and a mix of growth and value stocks. Within bonds, it may make sense to hold some issued by the U.S. Treasury, government agencies, and corporations. Spreading these holdings out across the maturity and credit quality spectrums would further broaden the portfolio.

The basic idea? To simply not put all your eggs in one basket. So when one market segment falls, you may be protected by gains in another. It is true that stocks generally provide the strongest returns over time, but they also have a bad habit of declining by 50 percent during nasty bear markets. Not too many investors can tolerate that sort of volatility. Diversifying into bonds or other asset classes can help protect your wealth during stock market downturns.

While the merits of diversification seem obvious, and are held to with religious fervor among investment professionals, those pursuing such an investment strategy over the past decade likely regret it. Stocks have significantly outperformed bonds, cash, real estate, commodities and just about every other asset class since the current bull market began in early 2009. Even worse for advocates of diversification: within stocks, large-capitalization growth stocks in the U.S. have outpaced effectively every other segment of the stock market. Looking narrowly, technology stocks have trounced those in every other industry.

Indeed, the S&P 500 Index of mostly large-capitalization domestic stocks has outperformed the MSCI EAFE Index of international stocks by an annualized 7.5 percent since the start of the bull market. Large-cap growth stocks have outperformed value stocks by an annualized 3.7 percent. The tech-heavy NASDAQ Index has outperformed just about everything else, with annualized returns of over 12.5 percent for the last decade.

In a market environment like today’s, diversification has become an irritant. Investors want returns in-line or ahead of the market in every environment, particularly over longer periods like 10 years.

Yet, we now have 10 years of data that says we should have been narrowly invested only in the largest growth stocks, not spread out across many different assets. The problem is that the investment world is one of statistical noise. There are no rules per se. There are guidelines, but even those only work most of the time.

The past is not a prologue in the investment world, but historical performance is still a strong reason many cite as their prime decision point on whether to invest or not. Caveat emptor if that is your approach to selecting investments, even when looking back 10 years.

If we look at another example of historical performance, it becomes clear that looking in the rearview mirror isn’t always the best approach. From 1969 to 2008, long-term Treasury bonds outperformed the overall stock market, despite the fact that stocks are supposed to provide superior long-run returns.

Forty years is certainly a long period of time, but would it have made sense to draw conclusions from this performance and move all your money into bonds in late 2008? As it turns out, no. From January 2009 through the third quarter of this year, stocks returned an annualized 15.5 percent versus only 2.9 percent for long-term Treasuries.

Despite what the data said back in 2008, intuitively, it had to seem like a bad idea to put all of your money into bonds. After all, bonds are higher up the capitalization spectrum, and therefore offer a lower risk profile. Over time, riskier stocks had to outperform, even if one anomalous period did occur.

Indeed, it is easy to find articles that talk about how investments work over the long term, but even over long time periods, odd things can happen. Stocks can underperform bonds, national stock markets can stagnate (think Japan), and diversification can fail to live up to its promises.

Unfortunately, there is no good way to predict, and therefore avoid, these events. Timing in and out of the market has been discredited repeatedly by academics and practitioners. The only good approach is to stick with the practices that are known to work over time—even if they do not work every time.

Diversification is certainly one of those practices. Just like today's environment, a diversified portfolio was a liability in the 1990s. Technology and internet stocks drove the market higher, but other market segments fell way behind. However, when the dot- com bubble burst in 2000, diversification showed its value. Large-cap growth stocks declined materially, but value, small-cap and international stocks and real estate all held up pretty well. For the decade starting in 2000, diversification worked as advertised, and not just at generating stronger returns. A more balanced portfolio would have saved quite a lot of downside risk as well.

Despite what the data said back in 2008, intuitively, it had to seem like a bad idea to put all of your money into bonds.

Looking ahead, it would not be surprising to see a variation on what happened in the 2000s. Valuations are quite a bit lower for value and small-cap stocks, and much lower for international stocks compared with domestic large-cap growth stocks. Perhaps a change of leadership in the stock market is overdue.

It is possible, as we have seen, for even the most sacred tenets of investing to fail to hold true over shorter periods. But that doesn't make them any less relevant for long-term investors. Diversification is the most sacred of those tenets.

Mark Armbruster is president of Armbruster Capital Management Inc. He can be reached at (585)381-4180 or marmbruster@armbrustercapital.com.