Does Diversification Still Matter? As Much as Ever.

*Why a diversified portfolio can help investors achieve their long-term goals*

**By**

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**Key Points**

- Two harsh realities threaten to compromise most investment objectives: first, markets are unpredictable and, second, investors can sometimes be their own worst enemies.

- A well-diversified portfolio seeks the highest potential return while striving to manage a given level of volatility.

- Goals, markets, and circumstances are all fluid; even a well-diversified portfolio is only as good as it is current, so be sure to periodically rebalance your portfolio.
The U.S. stock market hit a then-record high in October 2007, when the Dow Jones Industrial Average was higher than 14,000 points. This peak proved elusive as the market would soon begin a steep decline and, by the time the market bottomed in March of 2009, the Dow was down roughly 6,600 points—a 50% loss in a scant 17 months. Fast forward to the end of 2014 when the Dow finished at 17,823 points, up more than a staggering 150% from the 2009 lows. The recovery was indeed magnificent—as magnificent as the beginning of 2016 was daunting—showing us time and again that markets can be fraught with peril for investors who do not exercise the discipline needed to be successful. Let’s take a closer look at what we mean by this.

Investors who try to time when to buy and sell merely create two opportunities to get it wrong. So those who sold investments when the markets began to dip as described above risk losing out on a portion of the markets’ eventual rise, having been forced to also try and guess the right time to reinvest. While there is no approach that guarantees results, we believe the best solution for long-term investors is to have a well-diversified portfolio; without it, there are two harsh realities that may well compromise investors’ objectives: Markets are unpredictable and investors can sometimes be their own worst enemies.

The unpredictability of the markets
As the saying goes, “Prediction is very difficult, especially about the future.” This is certainly true of the capital markets. Part of what makes markets so hard to predict has to do with an ongoing flow of complex data, such as earnings, economic growth, and central bank policy, combined with geopolitical factors that could impact currency valuations, government control, etc. These many influences make it very difficult to predict which investments will outperform from year to year.

Asset classes like stocks and bonds were traditionally not correlated, meaning one tended to perform well when the other did not. So there was a time when merely having a stock-bond mix could provide a good amount of diversification. For a variety of reasons, this has become much less the case in recent years. And even if investors can guess whether stocks or bonds will outperform, there’s the far more challenging task of determining which type of stocks or bonds should do well. In 2010, for example, small-cap stocks were tops; in 2012, they were a dismal sixth out of eight asset classes; and, in 2013, they were back on top.

Essentially, the solution offered by diversification is to cover your bases. Consider the example of the shop owner who diversifies his business by selling umbrellas and sun block. He understands the sales of each are inversely correlated. When it rains, he sells many umbrellas, but no sun block. When the sun shines, the reverse occurs. While he may be able to sell more umbrellas when it’s raining if he hadn’t devoted shelf space to sun block, he knows the weather will turn and he needs to be ready for those sunny days. The lesson: Since we can predict neither the weather nor the markets, we should be prepared for all eventualities through robustly diversified portfolios that can see us through both sunny and rainy market cycles.

The emotional factor
If market unpredictability isn’t enough to vex investors, their own decision making can undermine their long-term investment success. Why do people behave in ways counter to their best interests and historical experience? What leads them to buy high and sell low when they should be doing the reverse? Emotions like fear and greed can move people to make irrational decisions. In a bull market, greed can push reason and common sense aside in the belief that prices will go higher irrespective of valuations (think the late 1990s’ “dot-com” bubble). Alternatively, during a market downturn, the fear of losing money can result in a “flight” impulse when the best move may be to do nothing or perhaps even buy more of the asset that’s declining quickly in price.

A well-diversified portfolio may improve performance…

The goal of a well-diversified portfolio—a robust mix of investments both across and within different asset
classes—is to seek the highest potential return while managing a given level of volatility. We would consider a portfolio comprising purely large-cap stocks and government bonds, for example, to be a concentrated portfolio, not a well-diversified one. Compared to a diversified portfolio, a concentrated one may bring higher returns for a certain period of time, but it would be expected to do so with greater ups and downs.

Compare the diversified and stock-only portfolios in Figure 1, which details the individual calendar year returns of each hypothetical portfolio. As the results indicate, between the years 2000 and 2014, the stock-only portfolio outperformed the diversified portfolio 53% of the time (8 out of 15 years), while underperforming 47% of the time (7 out of 15 years).

However, the extent of drawdown (loss in portfolio value) in the stock-only portfolio was significantly greater than in the diversified portfolio. Consequently, as Figure 2 shows, the outperformance by the diversified portfolio was as high as 60%. On a cumulative basis, from January 2000–December 2014, the diversified portfolio was up 147%, while the stock-only portfolio was up 86% (on a compounded return basis)—a difference of almost 61 percentage points.

As with any endeavor, the prospects for success improve with a plan. An asset allocation plan is a roadmap with a clearly defined goal and a carefully designed route based on proven, enduring portfolio construction principles. A plan helps provide an ongoing discipline to maintain a steady hand amid volatile markets or asset class bubbles. Portfolio allocations are never static since different asset classes will perform differently over time. These shifts in asset class weightings may result in an increased risk level for a portfolio.

For instance, after a sharp run-up in the stock market, a portfolio of 60% stocks/40% bonds may be transformed into one that is 70% stocks/30% bonds. With the added stock weight, the portfolio is now holding a greater risk exposure, a level perhaps higher than what you’re comfortable assuming. As a result, it’s important to periodically (typically, annually) rebalance your portfolio—where you sell assets that have risen in value, while buying those that have declined in value—to bring it back in line with your plan’s original asset allocation.
allocation. The subtle but smart benefit of this discipline is that it forces one to sell high and buy low.

To develop—or revisit—your portfolio and the asset allocation plan that can help you toward your long-term goals, reach out to your Investment Advisor.

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