**Diversification: A Risk Management Tool That Also Builds Strong Portfolios** by Wolcott Wheeler

[All charts in this draft that currently report 2014 YTD numbers will be updated to reflect finalized 2014 figures. – WW]

Lately, with the constant rise in equity values, diversification has fallen out of favor. Why should investors diversify when the most widely followed benchmark, the Russell 1000, is also the best-performing asset class? Why abandon a winning streak?

The answer: because even recently, some asset classes have outperformed stocks, as our charts below attest. Even last year, equities were not the highest-ranked asset class: real estate was.

While thus far equities have offered safety and returns, this condition won’t last forever. No economic trend does. In investment, it is important not to be lulled into believing that the future will resemble the past. Recently we have been gifted with a low volatility environment; but historically, no financial trend persists into perpetuity. Volatility is an eventuality for which investors will have to prepare.

Case in point: the financial crisis of 2008. Investors who were weighted wholly in equities were devastated when world equity markets crashed. But for those who diversified, the blow was cushioned—and some actually prospered, if they were properly positioned.

As an investment strategy, and as a form of risk management, diversification has three outstanding virtues:

1. It is the best method of maximizing risk-adjusted returns.
2. It is a shield against volatility.
3. It eliminates the need to pick winners. It protects investors from having to guess which asset classes will perform the best in any given time period.

Behavioral finance—the science of analyzing how investor psychology determines investment decisions, in all their permutations—forms the basis of Barclays investment philosophy, and of late in the financial world, it has been supplanting modern portfolio theory, which has held sway since the 1950s. In 2002, Princeton psychology professor Daniel Kahneman won the 2002 Nobel Prize in economics for his pioneering work in behavioral finance.

Behavioral finance teaches us to resist what is called the *recency bias*—the tendency for investors to believe that prevailing market conditions will predominate indefinitely. The current resistance to diversification is a clear manifestation of the recency bias—and in this essay, we will demonstrate why even recent market activity provides an argument for diversification.

If we analyze recent market trends, we see that currently many asset classes are reporting low returns relative to their 10-year average. Figure 1 demonstrates this.



**Figure 1**

In this chart, three indexes are noticeably falling short—the Custom Global High Yield and Emerging Markets, the MSCI World, and the MSCI EM. Only a real estate index—the FTSE EPRA/NSREI Developed—is outperforming.

Lulling many investors into a false sense of security today is the fact that in 2014, volatility across asset classes registered extraordinary lows relative to the last 10 years, as Figure 2 below informs us.



**Figure 2**

When we narrow our focus to one asset class—equities—we notice that equity volatility is notoriously low, as Figure 3 demonstrates:



**Figure 3**

All four of the above major indices exhibit volatility far below 10-year averages. This is what investors today regards as “the new normal.” But as a result of this mistaken assumption (a recency bias), when an event like the dramatic market selloff of October 2014 occurred and the S&P 500 plummeted 9.8% from September 19 to October 15,[[1]](#footnote-1) investors regarded it as an apocalyptic event; they were unaccustomed to that kind of volatility, when in reality, a 10% market correction would typically be considered a more normal and, in fact, expected eventuality for equity markets.

In 2014, according to many leading equity indices, equities as an asset class delivered lower returns than the 10-year average across the board. Figure 4 reveals this:



**Figure 4**

As Figure 4 shows, only the Russell 1000 has been outperforming the 10-year average; the Russell 2500, the MSCI EAFE and the MSCI EM have been lagging behind. At some point, this trend may likely reverse, with domestic small- and mid-cap stocks (represented by the Russell 2500) along with international stocks (in the MSCI EAFE and MSCI EM) outperforming their long-term trends, whereas U.S. large caps (in the Russell 1000) may revert to lower returns. Investors who shun other equity asset classes in favor of only U.S. large caps may have regrets when 2014’s trend reverses. [Is this a market recommendation that we can make in *Compass*?]

When we widen our scope to view the rankings of nine asset classes over the past ten years, it is an eye-opening event. If we study Figure 5 below, we easily understand that no one asset class always yields the highest returns.



**Figure 5**

In 2014, the leader in returns was real estate (13.7%). It was also ranked number one in 2006, 2010, and 2012. But 2013’s leader was developed market equities (26.7%), with almost *twice* the returns. Investors who weighted their allocations solely in real estate in 2013 might have missed out on some profitable opportunities.

But for truly remarkable returns, outstripping everything else on the chart, the unquestioned standout asset class for the past ten years was clearly emerging markets equities during the *annus terriblis* of 2009, with a return of 78.5%. Many investors overlooked those windfall profits because they regarded emerging markets equities as an asset class undeserving of respect.

For further evidence of the surprises the market can hold in store for us, let us examine 2014’s lowest-ranking asset class—commodities (-6.3%). But when we re-examine the chart, we note that commodities ranked second both in 2005 (21.4%) and in 2007 (16.2%). In 2010, commodities commanded third place, with 16.8%. Between 2004 and 2007, real estate and commodities enjoyed a period of prosperity. On the great chessboard of asset rankings, leading players are always trading places.

What conclusions can we draw from this analysis? One, certainly, is that in the field of investment, the future is utterly unpredictable. This is certainly an incentive not to over-concentrate in any one asset class. It is also wise not to pursue “the last big thing” (again, recency bias). The fluctuations of many tech stocks over time certainly bear this out.

When we analyze returns in a quarterly basis, as opposed to an annual one, we can observe that market fluctuations can be even more dramatic. Even recently there have been unstable periods where if you needed your money, it wasn’t there, as Figure 6 makes clear.

[Joe and Rob, please provide Figure 6, which you recommended, showing quarterly returns that reinforce this contention. Thanks!]

At this point, we would like to emphasize that investors have to live with their portfolios on a day-to-day basis, and not merely undertake an annual review. The market is shifting on a daily basis. The ups and downs of Figure 7, which tracks a single index over time, at times resemble a mountain range.

[Joe and Rob, please provide Figure 7, since you suggested we include a chart that tracks one index over time, showing its ups and downs. Thanks!]

In conclusion, we suggest that as an investor, it might be wise to sit down with your Investment Representative and discuss options for diversification that could be right for you. You might be surprised which investment vehicles are enjoying high yields currently and consider exposure. New instruments are being created constantly, and they might fit in with your long-range investment plans. Diversification, like asset allocation, is an important form of risk management, and it works.

[Do we want a marketing call to action at the end of a *Compass* article? Since this is a piece primarily aimed at clients in *Compass* readership, I decided to include one. If you folks would like a different ending, please let me know.]

**Sidebar**

**Behavioral finance: recency bias, familiarity bias, and framing bias**

The science of behavioral finance has uncovered a host of unconscious biases that motivate investors to act in irrational and unwittingly self-destructive ways. Here are the definitions of three biases that directly impact investor resistance to diversification:

***Recency bias***

Recency bias is the tendency to think that trends and patterns we observe in the recent past will continue in the future. Many investors evaluate their portfolio performance according to recent results and base their future investment decision based on extrapolation. Recency bias convinces us that whatever the markets have been doing lately will continue. It’s a fallacy.

***Familiarity bias***

In a series of experiments, behavioral scientists learned that when people are faced with a choice between two gambles, they will choose the one more familiar to them. Sometimes, they will select the more familiar gamble even if the odds of winning are *lower*. Because of our liking for familiarity, we feel more comfort with the known and more discomfort with the unknown. In an another experiment, subjects were asked to rank in order the performance of the economy or stock market of a given list of countries;they tended to assign a higher rankingtotheir home country's performance.

Bottom of Form

But as an investor, when you buy the familiar, you underestimate the amount of risk in the investment. Because you underestimate the risk, you do not take action to mitigate risk, such as

diversifying. As a result, you end up assuming more risk than desired—or understood.

***Framing bias***

Framing occurs when the context we use to frame a situation comes to define that situation. For example: would you prefer a $5 discount or avoid a $5 surcharge? It’s the same change in price, but the way it’s framed can affect consumer behavior.

In investing, “framing” is crucial – through what time horizon do we view our investment decisions? If we decide based on a one-year horizon, we act on short-term information. But if we frame our choices on a 10-year horizon, we can take in the long view.

1. Jon C. Ogg. [The Stock Market Joke of October: What Sell-Off?,](http://247wallst.com/investing/2014/10/31/the-stock-market-joke-of-october-what-sell-off/#ixzz3Mkob1i53) 24/7 Wall St.com, October 31, 2014,

 [↑](#footnote-ref-1)