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Diversifier's Remorse

Who needs diversification when the S&P is roaring like it is this year? Thoughtful analysis and portfolio construction seem like overkill when an investor could have purchased the SPDR ETF linked to the S&P 500 and pocketed 16.1% through August with the click of a button. There is even a good story to support such an approach – the Fed's stimulus program depends in large part on stock prices increasing. As for risk, no one is better than the Fed at creating a floor under stocks. Witness the Fed's reactions to previous market volatility: QE2 in November 2010, Operation Twist in September 2011, and QE3 in September 2012.

So what does it mean to have been diversified in 2013? This month we examine the results of a diversified portfolio in the year to August. Then we move beyond the eight month window and consider the longer-term implications of diversification and provide an interesting way to think about the opportunity cost of diversifying.

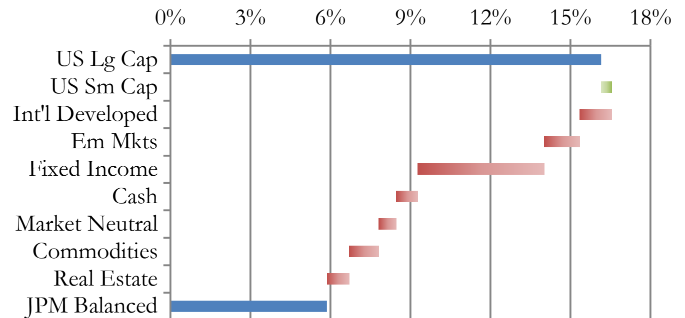
The Year so Far

Just about any decision to diversify a portfolio away from the S&P 500 has been penalized in 2013. Figure 1 is a depiction of how the diversification of the JP Morgan Balanced Benchmark (a proxy for a diversified portfolio used throughout this analysis) has, with one exception, detracted from the earnings an investor would have otherwise received from an S&P-only portfolio. Each asset class on the y-axis contributes to the JPM benchmark return relative to the S&P in two ways: 1) its weighted return (weights are given in the note below the chart) and 2) the foregone weighted return for eschewing the S&P. The green and red bars plot the net of those two contributions. Reading from top to bottom, we get off to a good start with US Small Cap equity which added 0.4% in incremental return.

Thereafter, each successive asset class detracted from performance. For instance, a 15% benchmark allocation to International Developed Equities at the expense of US Large Cap brought the return down from 16.5% (US Large Cap + US Small Cap) to 15.3%, a loss of 1.2%. Broad fixed income, an asset class that is down for the year, has cost the benchmark a whopping 4.7%. The aggregate of all of the contributions, positive and negative, brings the JPM benchmark to a 5.9% return for the year. Not a bad result for eight months, but a 10.3% give-up compared to the S&P-only portfolio.

Before drawing any conclusions from this analysis, we hope to show that what has been true in 2013 is not the norm. Many of the other asset classes that have detracted from performance should benefit a portfolio over the long-term from a return and/or risk perspective. We think the historical record for the benchmark's constituents bears out this viewpoint.

Figure 1: Playing Monday Morning Quarterback
Sources: JP Morgan, Morningstar



Figures 1 and *2* use the following indexes to proxy the parenthetical asset class; additionally, we give the weight of each index in the JPM Balanced Benchmark: S&P 500 (US Lg Cap, 25%), Russell 2000 (US Sm Cap, 10%), MSCI EAFE (Int'l Developed, 15%), MSCI Emerging Markets (Em Mkts, 5%), Barclays Aggregate Bond (Fixed Income, 25%), Barclays 1-3 mo. Treasury (Cash, 5%), DJ Credit Suisse Market Neutral (Market Neutral, 5%), DJ UBS Commodity (Commodities, 5%), and NAREIT All Equity REITs (Real Estate, 5%).

Picturing Diversification

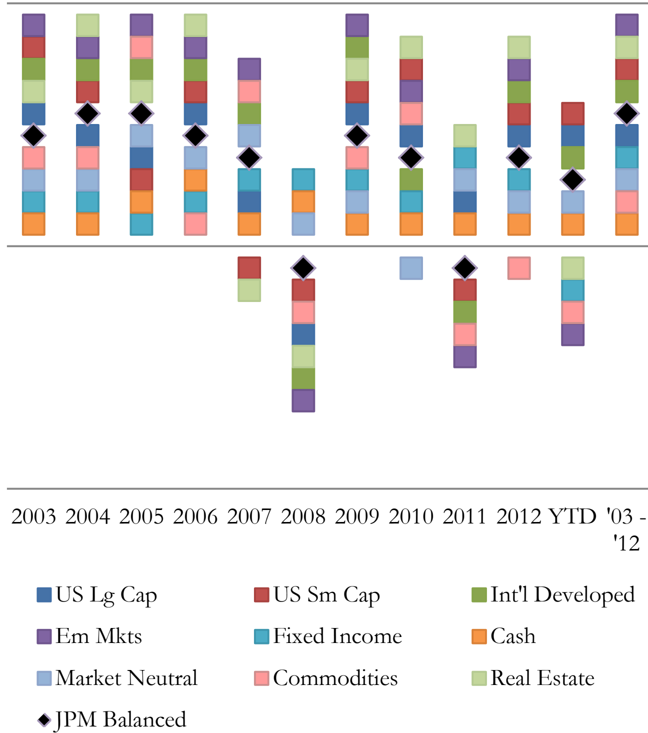
Figure 2 is our reproduction, with some small changes, of a chart that JP Morgan produces on a quarterly basis. We find it to be a helpful visual aid for thinking about diversification. The chart ranks the calendar year returns for each of the major asset classes or strategies that underlie the JPM benchmark. Any asset class in the stack above the middle line was positive for the year while those below were negative for the year. The further away from the middle line, the greater the asset class return (positive or negative). The black diamond represents the benchmark.

The takeaways for us are threefold. First, asset classes that tend to be at the top of the stack in the fat years are frequently at the bottom in the lean years. A concentration in these should lead to attractive long-run returns, but near-term volatility can put investors in the despair car on the emotional market rollercoaster.

Second, the fixed income and cash boxes always appear above the middle line, but are usually at the bottom of the positive stack (although fixed income is threatening to break the trend this year). Two problems: 1) those asset class returns alone are generally insufficient for clients to meet their investment goals and 2) we think the fa-

mous disclaimer – "past performance is not an indication of future returns" – is most applicable here. Hopefully this is a familiar refrain from us: traditional bond returns going forward will likely be significantly lower than they have in the past.

Figure 2: Ranking Calendar Year Returns
Sources: Morningstar for YTD stats; JP Morgan for all others
Data through 8/31/2013



Lastly, the diversified portfolio proxied with the JPM benchmark is relatively nondescript. It's never at the top of the stack, never even top three. While positive most years, there have been two years of the ten presented in which the result was negative. Crucially though, the black diamond has never been in the bottom four. Year to year results are somewhat boring, but we would submit that the diversification proxied here is a superb starting point for meeting the goals of a client with moderate risk aversion.

The Opportunity Cost of Diversification

We believe that most of our readers, never mind the occasional regret for not concentrating in the S&P 500 ETF in a year like this one, would prefer a diversified portfolio that seeks to manage risk as well as return. For those of you who fit that description, a more interesting question might be: "Am I paying too much for diversification?" rather than "Should I diversify at all?".

The first part of the answer is backward looking. The last column in Figure 2 gives the cumulative ranking of each of the indexes and the diversified portfolio. The S&P (deep blue) actually underperforms the JPM Balanced Benchmark; small caps, both non-US equity categories, and real estate all earned more. Over this period, those who diversified away from the S&P 500 were the payee.

Of course the next ten years will not play out the same way as the last ten. The S&P 500 could outperform the black diamond. So we look at the question a second way: from an insurance perspective. The cost of diversification might be compared to the cost of portfolio insurance in the form of put options (contracts that give the owner the option to sell, in this case, the S&P 500 back to the put issuer at a pre-negotiated strike price thus protecting against any downside below the strike). Would a simple strategy pairing an investment in the S&P with a put option (at-the-money) that protects against any market losses fare better than a broadly diversified portfolio? To address this we extended the analysis presented in the *July 2013 Bulletin* on the average cost and payoff for hedging with puts.

Over the ten year period from 2003 to 2012, the S&P 500 returned 7.1% annualized nearly doubling investor's money. Adding the put option hurts returns in the good years but saves money in the blow-up years. The end result is just 4.6% annualized over the same time period meaning insurance cost roughly 2.5%. We arrive at 1.7% if we extend the analysis to 1991.

Giving back 1.7% - 2.5% of S&P earnings on average each year may seem like a reasonable price for sleeping well. Over time, though, this strategy is costly. Since 1991, a $100 investment would have earned an extra $200 ($580 vs. $380) if insurance was foregone. We believe investors can do better. Our view is that a diversified portfolio may have an opportunity cost in a year such as 2013, but in the long run that cost is minimal or even a benefit (see '03 – '12).

Further, while this analysis has focused on the JPM benchmark, a good baseline for a diversified portfolio, we think our strategic use of alternatives can further improve portfolio results. To the extent that the 55% in total equity in the JPM benchmark and 25% in traditional bonds can be more efficiently accessed with hedged equity, non-traditional bonds, and other alternatives, we like our chances against the S&P or S&P plus insurance strategies even more. □

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