Don't Give Up On Diversification

When the final market bell rang in 2016, U.S. equity indices such as the S&P 500 and Dow Jones Industrial Average posted impressive fourth quarter gains of 3.82% and 8.66%, respectively. While these returns were remarkable, many investors were surprised by the relatively poor performance of their own accounts versus what they had witnessed in the large cap indexes. The main culprit was the fact that diversification away from U.S. equities in the fourth quarter did not work. Despite the fourth quarter difficulty, we continue to believe in diversification in portfolios.

Looking back over the past three months, the election victory of Donald Trump spurred the strongest post-presidential election equity rally in history. Investors anticipated that President-elect Trump would push Congress to enact his policies for infrastructure spending, deregulation and meaningful corporate tax cuts that, together, are expected to boost economic growth. However, as seen in the table below, strong fourth quarter performance was not seen in every major asset class. While U.S. stocks did well, foreign equity markets and even bonds lost ground. It was a very narrow rally in which large cap U.S. stocks were the main winners.

Chart 1

Asset Class	Representative Index	4Q 2016 Return
Concentrated Mega- cap U.S. Equities	Dow Jones Industrial Average	8.66%
Large Cap U.S. Equity	S&P 500	3.82%
International Equity	MSCI EAFE	-0.71%
Emerging Markets Equity	MSCI Emerging Markets	-4.16%
Global Equity	MSCI All Country World Index (ACWI)	1.19%
Domestic High Quality Bonds	Bloomberg Barclays Capital U.S. Aggregate Index	-2.98%
Municipal Bonds	Bloomberg Barclays U.S. Municipal Bond	-3.62%
60/40 Portfolio	60% MSCI ACWI/40% Bloomberg Barclays Capital U.S. Aggregate Bond	-0.48%

Source: Morningstar, TSIM; Data as of 12/31/2016

As a result, despite the much publicized fourth quarter market rally, most investors who utilized a more prudent investment strategy that focused on diversification, suffered. For example, as seen in Chart 1 above, the globally diversified MSCI ACWI equity index failed to keep pace with U.S. stocks. Furthermore, even a simple balanced portfolio comprised of 60% global equities and 40% percent fixed income lost money.

Despite the fourth quarter setback, we believe diversification still make sense. Diversification is the practice of spreading your investments around so that your exposure to any one type of asset is limited. Diversification is beneficial because it can improve a portfolio's performance in two primary ways – it helps to mitigate portfolio volatility and it allows you to target specific risk factors. Diversification does not guarantee a profit or protection from loss, however.

Mitigating Portfolio Volatility The most commonly cited benefit of diversification is the reduction of portfolio volatility. Generally, asset classes will not react in the same way to adverse events. In a diversified portfolio, when one investment is losing value, another is likely gaining value, and they tend to even each other out over the long term. The important point in portfolio diversification is that the asset classes should be from different parts of the market – the less they move in sync with each other, the better it is for your portfolio. If you own just one asset class or a few asset classes that are similar, you probably will not get much long-term volatility reduction benefits because they will likely react in a similar manner. If your portfolio is diversified across multiple asset classes, a negative move in one sector will likely be offset by positive results in others. This is likely to result in less volatility and enhanced risk-adjusted returns. For example, as shown in Chart 2 below, a portfolio consisting of 60% stocks and 40% bonds has a similar 10-year return to large cap U.S. equities but with much lower volatility (standard deviation) and a much higher return (Sharpe Ratio, a measure of risk-adjusted returns; higher Sharpe ratio indicates higher return per unit of risk).

Chart 2

	10-Year Return	10-Year Standard Deviation	10-Year Sharpe Ratio
S&P 500	6.95%	15.28%	0.4070
60% S&P 500/ 40% Bloomberg Barclays Capital U.S. Aggregate Bond Index	6.44%	9.06%	0.6301

Source: Zephyr Analytics, TSIM; Data as of 12/31/2016

Despite the fact that the narrow market led to large cap U.S. stocks being the big winner in the fourth quarter, one should not ignore diversification. Reducing portfolio volatility is very important in investing. It is easier to stay disciplined to long-term investment goals if your portfolio is relatively stable and not experiencing sharp fluctuations. In addition, lower volatility of returns tends to result in higher compounded returns over time.

Target Specific Risk Factors Generally speaking, portfolio risk can be divided between unsystematic and systematic risk. Unsystematic risk is essentially the risk tied to each individual company owned in a portfolio, such as a company missing its earnings estimates. Sometimes, unsystematic risk is called diversifiable risk. Because not every company in an asset class will miss estimates at the same time, money managers attempt to diversify away this risk by investing in companies that they perceive to be stronger (through active management) or can be diversified through owning more securities (through index or passive approaches).

Systematic risk is basically the risk that exists after unsystematic risk is reduced or eliminated through diversification. This is crucial because managing systematic risk is what allows you to design your portfolio to take the amount and type of risk you are comfortable with. While most investors focus their attention on which specific company to buy, history shows what actually drives your long-term performance is how you position your portfolio in terms of systematic risk. This type of risk is both unpredictable and impossible to completely avoid. It can be mitigated by working with your advisor to build an asset allocation strategy which works for you and also addresses systematic risk. Asset allocation, which is driven by mathematical models, should not be confused with diversification.

Diversification Makes Sense

During the fourth quarter, investors aggressively purchased U.S. equities on the heels of Trump's victory. Unfortunately, it was a very narrow market as many other asset classes traditionally held in diversified portfolios, such as international equities and bonds, sold off. The result of this divergence was that diversified investors generally saw poor performance in their accounts and questioned the validity of this portfolio strategy. Despite this temporary setback, we believe diversification continues to makes sense; it can help mitigate portfolio volatility over the long term and allow you to target specific risk factors. Both of these should help you pursue your goals with greater confidence. Depending on your investment objective, a diversified portfolio should consist of a mix of large caps, small caps, international and emerging markets stocks, high quality bonds, high yield bonds, and cash. Please see your financial advisor for specific asset class mixes for your specific investment goals.

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Glossary

*The **Bloomberg Barclays Capital U.S. Aggregate Bond Index**, which was originally called the Lehman Aggregate Bond Index, is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.*

*The **S&P 500** is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.*

*The **Barclays U.S. Municipal Bond Index** is an unmanaged, market-value-weighted index of investment-grade municipal bonds with maturities of one year or more.*

*The **MSCI ACWI** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed market country indexes included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey* and United Arab Emirates.*

*The **MSCI EAFE** is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted.*

***MSCI Emerging Markets** is designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index.*

*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.*