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Money Matters | Is diversification dead? Do the math

Last year was a tough one for investors to make money in a widely diversified portfolio of stocks and bonds.

In fact allocations thought to be cutting edge (including international exposures, commodities, real estate and hedged strategies) produced negative returns in most scenarios. Unfortunately 2011 proved to be a year where simple was superior, as many asset classes failed to keep up with U.S. Treasuries (Barclays Capital U.S. 7-10 Year Treasury Bond Index: +15.5%) and U.S. Large Caps (S&P 500: +2.1%). A simple portfolio with a 50% / 50% allocation to the Barclays Capital U.S. 7-10 Treasury Index and the S&P 500 Index would have returned close to 9% for 2011. A 9% return would likely have made most investors very happy.

Financial advisors often manage their clients' portfolios using the follow principals:

• Asset Class Diversification. Identify which asset classes to use and determine what percentage to use in each portfolio. The effort is to identify and combine asset classes that are minimally correlated (read: that do not typically move together) in an attempt to diversify and reduce risk and/or increase returns over time.

• Rebalancing. Establishing an active process of rebalancing the portfolio back to its allocation targets and/or making tactical shifts in response to changes in the markets.

• Manager selection. Belief that the value of minimizing draw downs (peak-to-trough loss) is more helpful when compounding returns over time than maximizing the capture of the upside movements in the markets. Advisor look for managers who not only have the ability to make good investment purchases, but also have a disciplined process to avoid the full extent of market sell-offs.

• Reason for Bonds and Cash. Although portfolios are generally constructed to capture economic growth over time, advisors feel the need to select assets in the portfolio that are likely to have a low or negative correlation to stocks. High quality domestic bonds and cash have historically provided a form of systemic hedge against severe market downturns like we experienced in 2008.

Three of the four principles did not work well in 2011. The only one that worked well was number four, the systemic hedge in the portfolio of high quality domestic bonds and cash. Diversification into other equity classes besides the S&P 500 generally did not reduce volatility and they often detracted from returns. Rebalancing did not tend to help as asset classes that sold off the most continued to underperform as the year went on. Finally some managers were challenged to outperform their respective indices due to high correlations across most stocks.

The results from 2011 were driven less by fundamentals and more by fear. Even though the U.S. lost its AAA rating, investors flocked to U.S. Treasuries, which in turn made them the best performing asset class. The ten-year U.S. Treasury bond ended the year with a yield just short of 2%. Except out of fear, how many of you want to lend $25,000 to the U.S. Treasury for ten years for a 2% annual return?

But is diversification truly dead? Diversification over the past ten years was more rewarding. The Morningstar Moderate Index represents a balanced portfolio of 60% global equities and 40% bonds and traditional inflation hedges such as commodities and TIPS. The index had an annualized return of 6% for the ten-year period ending December 31, 2011. The S&P 500 Index had a total return of 2.9% for the same ten-year timeframe.

Asset diversification does not guarantee less risk and higher investment returns, but recent history shows that it does offer a less volatile method of investing over a complete market cycle of peaks and troughs.

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