Don’t Be Fooled
Diversification is Far From Dead!
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I imagine you went through 2013 without your home burning down and if so, great. Nevertheless, I hope you’re not thinking about canceling your homeowners insurance simply because you avoided disaster. That would be foolish just as it’s unwise for investors to think that diversification doesn’t play a crucial role in their portfolios.

**Frustration can lead to dangerously reactive decisions.** We’re only human and it’s quite understandable that an investor might look at the S&P 500 gaining over 30% last year and be disappointed with the “lousy” amount they generated from a well-diversified portfolio. And the more diversification a portfolio had, the more it trailed the U.S. stock market. Sure, domestic stocks considerably beat foreign stocks. However, they really shined against other investments, especially bonds (U.S. and foreign), emerging market stocks, commodities and REITS. In fact, it’s been 15 years since we’ve seen such dominance by U.S. equities compared to all other asset classes - remember domestic equities, especially tech stocks, trouncing commodities and nearly all other asset classes in the late nineties?

So is it fair for an investor to conclude that diversification doesn’t work? Not at all. Diversification did work in 2013 (U.S. stocks rose, bonds fell...). It simply was one of those rare years when diversification, despite working, didn’t “pay off”.

We view this market as a dangerous time for investors and NOT because we’re forecasting a great decline. Rather, we fear these markets may seduce investors into behavior that can be extremely harmful to their portfolios. Here are several worthwhile considerations:

**How soon we forget.** How much did U.S. stocks decline in the past two downturns and was it really that bad? Many investors forget that the S&P 500 fell 51% from October 2007 to March 2009 and 45% from August 2000 to September 2002. Put another way, on average, investors lost roughly fifty cents of every dollar invested in U.S stocks. That’s painful and something to consider as we’re tempted to diversify less.

**Will my bonds get crushed when rates rise?** The surprising answer is...not likely. We’ve carefully analyzed bond performance in prior rising rate environments and of course bond prices fall when rates rise. However, during the last six rising rate scenarios, bonds actually posted positive total returns each and every time. See [Don’t Panic About Your Bonds](#).

**Should I even include emerging markets in my portfolio?** Yes, 2013 was harsh with the MSCI EM Index declining more than 2%; however, over the past 10 years, EM stocks were either the absolute best or second best performing asset class of the 18 commonly tracked categories. Click here for [Why Diversify](#). Moreover, investing in emerging markets still offers many benefits including higher growth rates, lower debt levels and more reasonable valuations.

**Why even own commodities and TIPS in a low inflation environment?** True, commodities have not rewarded investors for several years yet they’ve historically provided some protection against inflation and geopolitical risks. TIPS, or inflation-protected securities issued by the U.S. Treasury, offer similar advantages. Given tumultuous fiscal and monetary challenges here and abroad, we believe it’s wise to have some exposure to real assets in anticipation of rising inflationary pressures.
I've identified merely a few investments that may be testing your patience but there certainly are others such as real estate, hedge funds, emerging markets debt and more. Virtually anything other than traditional stocks might very well feel like a thorn in your portfolio's side. So what's an investor to do? We recommend the following:

1. **Don’t be fooled and abandon diversification at “just the wrong time”**. Unless controlling risk is not important to you, take comfort in knowing that well diversified portfolios historically provide the majority of the stock market’s upside with substantially less risk over full market cycles.

2. **Acknowledge that we don’t know what we don’t know**. When will you need inflation protection in your portfolio? What will derail the rally in U.S. stocks? When you appreciate that an earthquake and subsequent tsunami in Japan literally initiated the market pullback in 2011, it becomes clear that the answer to these and similar questions is that no one knows with exact precision. Study after study show that market timing doesn’t work over extended periods.

I admit it! In a roaring stock market, adhering to time-tested principles like “prudent diversification” can be challenging. There’s nothing sexy about diversification and at times, it feels outright boring. So let me close with valuable insight from one of the greatest investors of all time.

“**The only investors who shouldn’t diversify are those who are right 100% of the time.”**

- Sir John Templeton