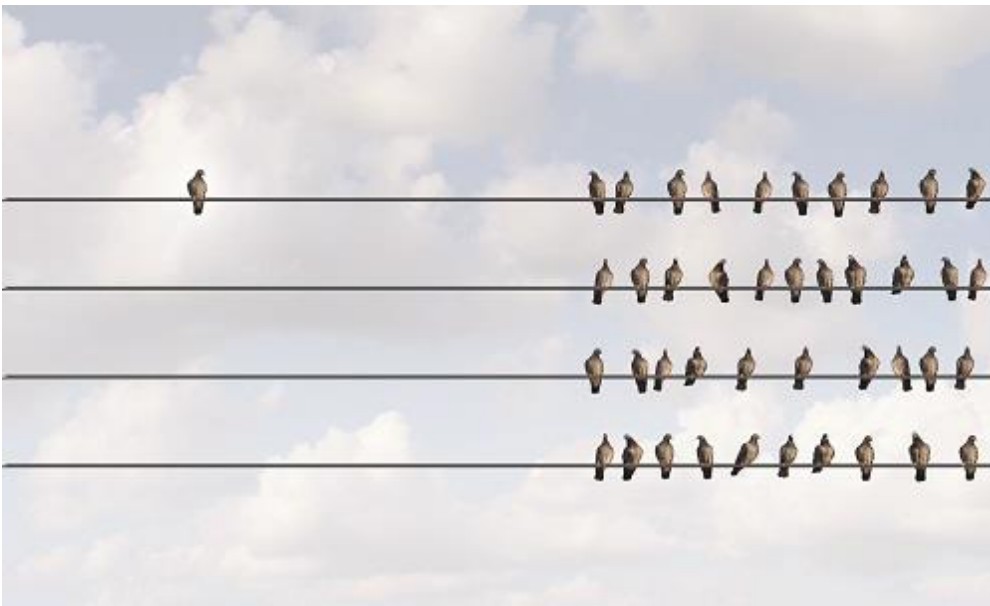# Does Diversification Trump Performance?

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Every good planner preaches the glory of diversification. It is a core investing philosophy and a committed approach, rather than a trendy tactic. But here's a reality that is less pleasant to disclose to a client: A diversified portfolio will never be the best performer in any given year.

The best performer over short time frames will always be a single asset class that is currently in favor. Comparing a broadly diversified portfolio with the best performer of the year is complete nonsense, yet many clients can't resist doing it.

History shows that the best performing investment in any year will be the stock of a company that relatively few people are actually invested in. For example, the best-performing stock in 1999 (Xcelera.com) had a one-year return of 11,060%, compared with a return of 314% turned in by the best-performing mutual fund (MAS Small Cap Growth Institutional). In 2000, the best-performing stock (Stocker & Yale) had a return of 1,786%, compared with 96.2% for the best-performing mutual fund (Nicholas-Applegate Global Health).

The same pattern plays out every year — the best performer is always a single stock, never a stock mutual fund. A diversified group of equities can never outperform the best-performing single stock. So why would anyone invest in a mutual fund? Because we make a philosophical decision to diversify, knowing full well that our approach will not produce the best return. For all practical purposes, the best return is unachievable.

ANALYZING ASSET CLASSES

Let's extend this same logic to the various asset classes that make up our investment universe. We can invest in large-cap U.S. stocks, midcap U.S. stocks, small-cap U.S. stocks (and, of course, we can tilt toward growth or value along the way), non-U.S. developed-market stocks and non-U.S. emerging-market stocks, real estate, commodities, technology, U.S. bonds, non-U.S. bonds, inflation-protected bonds, managed futures, cash and so on. It's a really long list if we keep going.

How can we know at the start of each year which asset class will be the best performer going forward? We can't — no one can. Thus, we build a diversified portfolio that incorporates a variety of asset classes, which is the fundamental premise of asset allocation — an open admission that we can't predict the future. If we could, we would certainly never diversify.

But here's the rub: When we build a broadly diversified portfolio, it will contain some asset classes that do well in the current climate, and some that will be underachievers. That is the real challenge of diversifying: being patient as we watch the various ingredients in our portfolio take their turn being the hero — and the goat. If we're not careful, our emotions will lead us to chase the heroes (by putting more money into the best-performing asset classes of the recent past) and dump the goats (selling the underperforming asset classes).

Interestingly, many investors claim to want a low-correlation portfolio that includes ingredients that do not all zig and zag at the same time. But when a few of their portfolio ingredients zag downward while other portfolio ingredients are zigging upward, the investor frets about the underperforming zaggers and becomes angry he owns a fund or stock that is losing money.

Many investors talk the talk, saying that they want a low-correlation portfolio, but they can't — or won't — walk the walk and actually experience one.

Building and maintaining a diversified portfolio is an exercise in patience — and perspective. Without a core philosophy, many investors simply cannot weather the short-term storms, and this leads them to chase the hot-performing asset class of the month, quarter or year. But, over longer time frames, the logic of broad diversification works out. The investor just has to be willing to wait for the longer-term rewards.

PERIODIC TABLE OF PERFORMANCE: FROM LESS DIVERSIFIED TO MORE DIVERSIFIED

Average annualized returns of five investment portfolios ranging from one asset class to 12 asset classes.

Portfolio	Portfolio Composition	1–Year Return	3–Year Return	5–Year Return	10–Year Return	15–Year Return
1–Asset Portfolio	100% Large U.S. Stock	2.75	16.09	14.40	7.48	5.15
2–Asset Portfolio	60% Large U.S. Stock / 40% Bonds	2.27	10.19	9.95	6.64	5.45
4–Asset Portfolio	40% Large U.S. Stock, 20% Small U.S. Stock, 30% Bonds, 10% Cash	2.81	10.20	9.65	6.56	6.15
7–Asset Portfolio	14.28% Allocation to Large U.S. Stock, Small U.S. stock, Non–U.S. stock, Real Estate, Commodities, U.S. Bonds, Cash	–3.08	4.47	5.76	4.97	6.59
12–Asset Portfolio	8.33% allocation to Large U.S. stock, Midcap U.S. stock, Small U.S. stock, Non–U.S. stock, Emerging Stock, Real Estate, Natural Resou modities, U.S. Bonds, TIPS, Non–U.S. Bonds, Cash	–4.93	2.67	4.36	5.20	7.08

Source: Lipper, calculations by author. Performance data as of Nov. 30, 2015.

RECIPES OF DIVERSIFICATION

Consider several different levels of diversification over the past 15 years (from Dec. 1, 2000, to Nov. 30, 2015). As shown in the "Periodic Table of Performance" below, the first investment model consists entirely of large-cap U.S. stocks, as measured by the S&P 500. This first model is diversified among 500 U.S. stocks, but not among asset classes.

The second model is 60% S&P 500 and 40% U.S. bonds (Barclays Aggregate Bond Index), which represents a very minimally diversified portfolio in that it contains only two asset classes.

The third model is a four-asset portfolio with a 40% allocation to the S&P 500, a 20% allocation to the S&P SmallCap 600 Index, a 30% allocation to the Barclays Aggregate Bond Index and a 10% allocation to 90-day Treasury bills.

Next is a seven-asset portfolio. This adds non-U.S. stocks (MSCI EAFE Index), real estate (Dow Jones U.S. Select REIT Index) and commodities (Deutsche Bank Liquid Commodities Index) to the four-asset portfolio, with each ingredient equally weighted at 14.3%.

Finally, we have a 12-asset portfolio, equally allocated among 12 indexes (S&P 500, S&P MidCap 400, S&P SmallCap 600, MSCI EAFE, MSCI Emerging Markets, Dow Jones U.S. Select REIT, S&P North American Natural Resources Sector, Deutsche Bank Liquid Commodities Optimum Yield,

Barclays U.S. Aggregate Bond, Barclays U.S. TIPS, Barclays Global Treasury ex-U.S. and three-month U.S. Treasury bills).

All the multi-asset-class portfolios assumed monthly rebalancing. Over the 12-month period from Dec. 1, 2014, to Nov. 30, 2015, the four-asset portfolio was the best performer.

Over the three-year, five-year and 10-year periods ended Nov. 30, 2015, the one-asset class investment (100% S&P 500) was the best performer. Finally, over the 15-year period, the value of a broadly diversified approach manifested itself with an annualized return of 7.08%, compared with 5.15% for the one-asset-class S&P 500 investment.

It's interesting to observe that the 15-year performance systematically improves as the degree of diversification rises from a one-asset class investment to a 12-asset-class portfolio.

It's important to consider the "pathway to performance," rather than just the ending outcome. As shown in "10-Year Growth of $10,000" below, the one-asset investment (100% S&P 500) had an account balance that was lower than the 12-asset portfolio for most of the 10-year period from Dec. 1, 2005, to
Nov. 30, 2015.

Only in recent years did the one-asset portfolio account balance rise above the more diversified 12-asset portfolio. In fact, for 80% of the 10-year period, the more diversified portfolio had a higher account balance.
Success along the way matters to investors, precisely because too many of them are focused on the short run. Diversification tends to produce a more stable pattern of growth over time compared with less-diversified portfolios. But, as a result, a broadly diversified approach will lag behind when one particular asset class (say, large-cap U.S. stocks) is on a hot streak.

10–YEAR GROWTH OF $10,000
Between December 2005 and November 2015, a diversified portfolio outperformed a single–asset portfolio (S&P 500) 80% of the time.
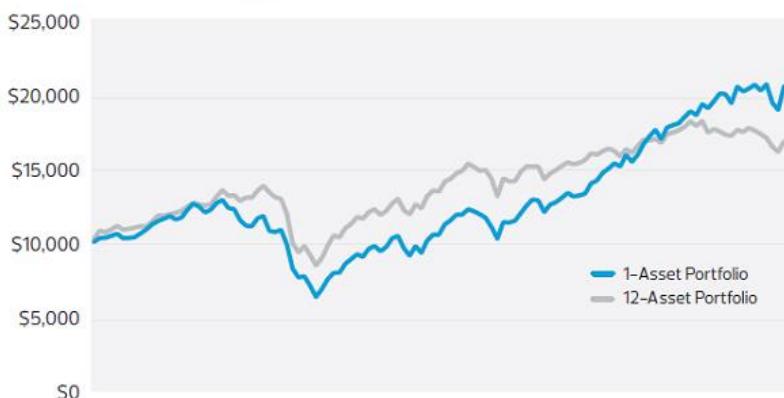
Source: Lipper, calculations by author

HOT STREAKS

When investors are chasing performance, they abandon their investment philosophy of diversification and chase after an asset class that is delivering impressive shorter-term results.

I'm not suggesting that three-year and five-year performance results are irrelevant. But shorter-term results should not cause an otherwise philosophically grounded investor to abandon a diversified approach.

In an era of short sound bites, investors who react to noise will end up chasing hot securities and churning their portfolios from one design to another. The solution to self-churning is to have a well-articulated investment philosophy that guides us through the short-run noise toward the long-run results we seek.

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