Reprinted from:
THE NATION'S OLDEST WEEKLY BUSINESS JOURNAL
DENVER BUSINESS JOURNAL
VOL. 60 NO. 50 May 22 - 28, 2009 40 PAGES $2.00

Diversification didn't help as much as hoped in 2008

RICHARD TODD
PERSONAL FINANCE

In March, 264 investment professionals were asked to judge whether this statement is true or false: "Diversification failed investors in the current financial crisis." The question appeared to be controversial: Fifty percent answered true, and 50 percent said it was false.

Had this same question been addressed to individual investors or to investment committees, a strong majority probably would have answered "true." Not only were stocks down severely in 2008, but investors felt there was no available shelter in the worst financial storm since the 1930s.

Because diversification is considered a cornerstone of modern portfolio management, it is only reasonable to evaluate whether or not it stands up to severe tests like 2008. Such an analysis needs to take into account that diversification takes several distinct forms, each of which need to be examined separately.

Diversification among securities

When nearly all U.S. stocks fell in 2008, investors with a large number of stocks did not come even close to offsetting their losses. However, that did not mean diversification among individual stocks didn't provide meaningful advantages.

According to investment research firm Morningstar, only one domestic stock fund (excluding leveraged offerings) out of 15,272 lost more than 75 percent last year. In contrast, 2,886 of the 10,691 stocks in Morningstar's database of U.S. stocks (27 percent of the companies) declined in value by more than 75 percent.

Among different styles

Sub-components of asset classes, such as growth and value, did not provide much performance differential in 2008. Among large-cap U.S. stocks, style returns were fairly close to one another:

S&P 500: -37.0%

S&P 500 Growth: -34.9%

S&P 500 Value: -39.2%

Stock-market history also demonstrates that it would be unreasonable for investors to expect one style to be up significantly when the other style has severe losses. And there are no guarantees that one style will consistently outperform the other in either up or down markets.

Among different capitalizations

Diversification among U.S. stocks of different capitalizations also offered little benefit in 2008:

Large-cap U.S. stocks: -37.0%

Mid-cap U.S. stocks: -36.2%

Small-cap U.S. stocks: -31.1%

Last year served to remind investors that they should not rely on small- or mid-cap stocks to be up dramatically when large-cap stocks are down, and vice versa. Mid- and small-cap stocks should be owned primarily for their potential of long-term appreciation.

In the seven years ended Dec. 31, 2008, small-cap stocks outperformed U.S. large caps by an average of 4.6 percent per year.

Among different asset classes

The two largest asset classes are commonly defined as stocks and bonds. Their 2008 returns were dramatically dissimilar:

Large-cap U.S. stocks: -37.0%

Investment-grade U.S. bonds: +5.2%

In the seven negative years for U.S. stocks between 1976 and 2008, investment-grade U.S. bonds had positive returns in every one of those years. This historical relationship should not be considered a future guarantee, however. Considering bonds' low nominal interest rates and their vulnerability to the fear of rising inflation, it is possible for both U.S. stocks and bonds to decline concurrently in future years.

The returns of other assets, often classified as "alternatives," were far from positive in 2008:

Hedge funds: -20.4%

Commodities: -35.6%

Part of what made 2008 so painful for many investors is that outside of cash (T-bills were up 2.1 percent) and high-quality bonds (up 5.2 percent), losses in most other asset classes were so severe — down 20 percent to 53 percent. In times of financial crises, risky assets tend to decline in tandem.

Although diversification did not help as much as investors would have liked in 2008, it did not die a premature death. In particular, meaningful allocations to high-quality bonds enhanced 2008's returns.

Over long periods of time, most asset classes do not move in tandem and asset-class diversification offers the potential for smoother portfolio returns.

Steps to take now

These proven steps should help investors build stronger long-term portfolios:

- Know your downside risk tolerance. Review worst-case scenarios for your portfolio, and don't let good markets lull you into taking on more risk than is prudent for your situation.
- Pay close attention to when you may need to make major distributions from your portfolio. Don't take risks with those monies needed in the near-term.
- Select asset classes for your portfolio with reasonable, forward-looking, long-term expectations of what each asset class should return.
- Consider the historical advantages of adding to your portfolio high-quality bonds (and other conservative investments) to lessen volatility and to reduce portfolio losses.
- Among equities, invest in different styles, capitalizations and geographies for long-term enhanced returns, not for protection in crises.
- When investing a portion of your portfolio in alternative investments, realize that they may be inconsistent in adding downside protection.
- Always diversify among individual securities in each asset class. Lack of diversification among individual securities adds unnecessary risk.
- Be patient in the midst of market volatility and disappointing returns. Don't let emotions manipulate your decisions.
- Rebalance your portfolio periodically. Taking profits in up markets can be difficult because it is easy to get caught up in the excitement of making money and taking on more risk. It also takes stamina to buy low when fear and panic are prevalent.

Innovest Portfolio Solutions LLC provides investment consulting services to retirement plans, foundations, endowments and wealthy individuals. We can be reached at (303) 694-1900.
Rich Todd can be emailed at richt@innovestinc.com