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Diversification: It's Not Always Easy to Do the Right Thing

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Kevin P. Barr
Head of Investment Management Unit

Snapshot

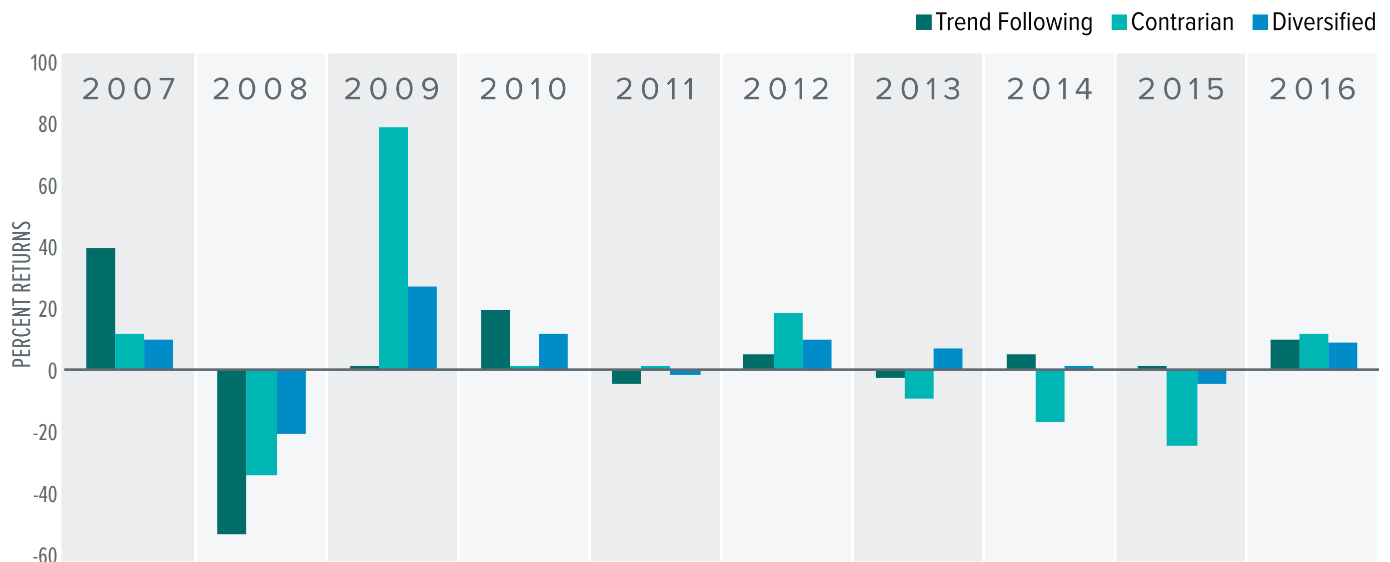
- Year in and year out, a single index will often outperform a well-diversified portfolio.
- Yet outperformance is difficult to predict—and over time, the diversified portfolio tends to outperform despite consistently falling short in any single year.
- Although it often leads to challenging conversations between financial advisors and investors, we believe diversification is the right approach.

Everybody loves a winner

In a world where the latest record high on the Dow Jones Industrial Average or the S&P 500 Index dominates financial headlines, the traditional well-diversified investment portfolio has fallen out of favor. Diversification is a time-tested method of portfolio construction that reduces risk (standard deviation) and delivers more consistent returns, but what it doesn't do is make headlines by delivering attention-grabbing performance. Accordingly, investors are often disappointed when they compare the results of a diversified portfolio with the results of a single index.

Diversification rarely wins in any given year...

As a result, many investors want to buy last year's winner; in the short-term, this strategy sometimes works well. Over the past 10 years, a trend-following strategy—one that invests in the top-performing asset class from the prior year—would have been the top performer 40% of the time. Similarly, a contrarian strategy—one that invests in the worst-performing asset class from the prior year—would also have been the top performer 40% of the time. A diversified strategy that invested equally in each asset class would have been the top performer only 20% of the time.



SOURCE: SEI/Bloomberg
Past performance is no guarantee of future results.

...But diversification also rarely loses

Looking solely at how often each strategy outperforms tells only part of the story. If we look at the number of times each strategy was the bottom performer, we observe that both the trend-following and contrarian styles finished worst 40% of the time.

The diversified portfolio finished last in just two out of 10 years, returning 10.0% in 2007 and 8.4% in 2016—robust gains that are above the long-term expected and historical average returns for a diversified strategy.

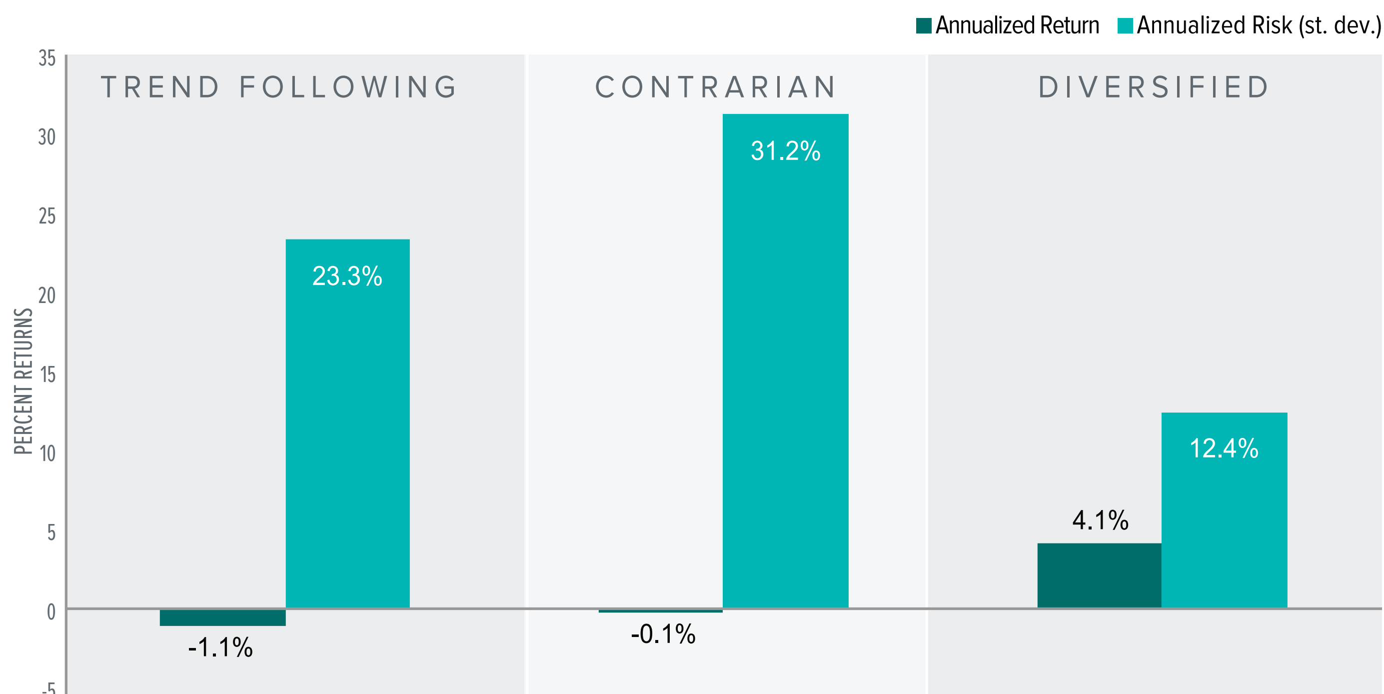
The proof

While the trend-following and contrarian strategies often have the best opportunity to outperform, they also have the highest tendency to underperform. The diversified strategy may not offer the same opportunity for short-term gains, but the relative stability helps to avoid significant losses in a given year. Over longer, multi-year periods, a strategy that successfully avoids significant losses will tend to outperform, and experience less volatility. This is the reason responsible financial advisors recommend diversification as the right thing to do for their clients.

If we examine the 10-year period as a whole, we observe that the contrarian strategy actually lost value despite being the top performer in four separate years. This resulted in an average loss of 0.1% per year and came with stunningly high volatility of 31.2% annually. The trend-following strategy performed even worse, losing 1.1% annually; although volatility was a bit better at 23.3%. The diversified strategy outpaced both with an average gain of 4.1% and only 12.4% volatility. It's quite clear that the strategy with the most consistent returns comes out on top in the long term.

It's not always easy to do the right thing

Over the past decade, prudent financial advisors have had to defend performance of well-diversified portfolios in eight out of 10 annual client meetings. While this task may seem daunting, just imagine having to defend a trend-following emerging-market equities portfolio after it plummeted by 53.3% in 2008. The contrarian strategy presented similar challenges following consecutive losses of -9.5%, -17.0% and -24.7%, respectively, from 2013 – 2015, in a portfolio concentrated in commodities.



SOURCE: SEI/Bloomberg
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Chart disclosures

Asset-class returns are based on the same indices as indicated below. Performance begins 1/1/2007 and continues through 12/31/2016. In each of these years, “Trend Following” uses the current-year return of best-performing asset class of the previous year. “Contrarian” uses the current year return of the worst-performing asset class of the previous year. “Diversified” uses a return equal to the return of a portfolio of equally weighted asset-class returns in each year.

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Emerging Equity 39.4%	Short Dur. Gov’t 6.7%	Emerging Equity 78.5%	US Small Cap 26.9%	TIPS 8.9%	Emerging Equity 18.2%	US Small Cap 38.8%	US Large Cap 13.2%	Emerging Debt 1.2%	US Small Cap 21.3%
Commodities 16.2%	IG Fixed Income 5.2%	High Yield Bonds 58.1%	Emerging Equity 18.9%	IG Fixed Income 7.8%	Emerging Debt 17.4%	US Large Cap 33.1%	Emerging Debt 7.4%	US Large Cap 0.9%	High Yield Bonds 17.5%
TIPS 11.4%	Cash 1.8%	Int’l Equity 31.8%	Commodities 16.8%	Emerging Debt 7.3%	Int’l Equity 17.3%	Int’l Equity 22.8%	IG Fixed Income 6.0%	Short Dur. Gov’t 0.6%	US Large Cap 12.1%
Int’l Equity 11.2%	TIPS -2.4%	Emerging Debt 29.8%	US Large Cap 16.1%	High Yield Bonds 4.4%	US Large Cap 16.4%	High Yield Bonds 7.4%	US Small Cap 4.9%	IG Fixed Income 0.5%	Commodities 11.8%
Short Dur. Gov’t 7.3%	Emerging Debt -12.0%	US Large Cap 28.4%	High Yield Bonds 15.1%	Short Dur. Gov’t 1.6%	US Small Cap 16.3%	Short Dur. Gov’t 0.4%	High Yield Bonds 2.5%	Cash 0.0%	Emerging Equity 11.2%
IG Fixed Income 7.0%	High Yield Bonds -26.1%	US Small Cap 27.2%	Emerging Debt 12.2%	US Large Cap 1.5%	High Yield Bonds 15.5%	Cash 0.0%	TIPS 0.9%	TIPS -0.5%	Emerging Debt 10.2%
Emerging Debt 6.2%	US Small Cap -33.8%	Commodities 18.9%	Int’l Equity 7.8%	Cash 0.1%	TIPS 5.0%	IG Fixed Income -2.0%	Short Dur. Gov’t 0.6%	Int’l Equity -0.8%	TIPS 4.0%
US Large Cap 5.8%	Commodities -35.7%	TIPS 12.0%	IG Fixed Income 6.5%	US Small Cap -4.2%	IG Fixed Income 4.2%	Emerging Equity -2.6%	Cash 0.0%	US Small Cap -4.4%	IG Fixed Income 2.6%
Cash 4.8%	US Large Cap -37.6%	IG Fixed Income 5.9%	TIPS 5.2%	Int’l Equity -12.1%	Short Dur. Gov’t 0.4%	Emerging Debt -5.3%	Emerging Equity -2.2%	High Yield Bonds -4.6%	Int’l Equity 1.0%
High Yield Bonds 2.5%	Int’l Equity -43.4%	Short Dur. Gov’t 0.8%	Short Dur. Gov’t 2.4%	Commodities -13.3%	Cash 0.1%	TIPS -5.6%	Int’l Equity -4.9%	Emerging Equity -14.9%	Short Dur. Gov’t 0.9%
US Small Cap -1.6%	Emerging Equity -53.3%	Cash 0.1%	Cash 0.1%	Emerging Equity -18.4%	Commodities -1.1%	Commodities -9.5%	Commodities -17.0%	Commodities -24.7%	Cash 0.3%

SOURCE: SEI/Bloomberg

Index definitions

US Large Cap = Russell 1000 Index, US Small Cap = Russell 2000 Index, Int’l Equity = MSCI EAFE Index, Emerging Equity = MSCI Emerging Markets Index, IG Fixed Income = Bloomberg Barclays U.S. Aggregate Bond Index, High Yield Bonds = BofA ML US High Yield Constrained Index, Emerging Debt = JPM EMBI Global Diversified Index, TIPS = Bloomberg Barclays US TIPS 1-10 Year Index, Short Dur. Gov’t = Bloomberg Barclays US Treasury 1-3 Year Index, Commodities = Bloomberg Commodity TR Index, Cash = Bloomberg Barclays 1-3 Month US Treasury Bill Index

The Bloomberg Barclays 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and nonconvertible.

Index definitions (continued)

The Bloomberg Barclays 1-10 Year US TIPS Index measures the performance of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of one to ten years.

The Bloomberg Barclays US Aggregate Bond Index is an unmanaged benchmark index composed of U.S. securities in Treasury, government-related, corporate, and securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.

Bloomberg Barclays U.S. Treasury 1-3 Year Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one to three years.

The Bloomberg Commodity TR Index is made up of 22 exchange-traded futures on physical commodities. The Index currently represents 20 commodities, which are weighted to account for economic significance and market liquidity. Weighting restrictions on individual commodities and commodity groups promote diversification.

The BofA Merrill Lynch US High Yield Constrained Index measures the performance of high-yield bonds.

The JPMorgan EMBI Global Diversified Index tracks the performance of external debt instruments (including U.S. dollar-denominated and other external-currency-denominated Brady bonds, loans, eurobonds and local-market instruments) in the emerging markets.

The MSCI EAFE Index is an unmanaged, market-capitalization-weighted equity index that represents the developed world outside North America.

The MSCI Emerging Markets Index is a free float-adjusted market-capitalization weighted index designed to measure the performance of global emerging-market equities.

The Russell 1000 Index includes 1,000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

The Russell 2000 Index includes 2,000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

Disclosures

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