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Diversification: The Boring Winner

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Snapshot

- Year in and year out, a single asset class will often outperform a well-diversified portfolio.
- Yet outperformance of any single asset class is notoriously difficult to predict, and a diversified portfolio will tend to outperform over the long run, especially in risk-adjusted terms.
- Although the middle-of-the-road performance tendencies of diversified strategies can lead to challenging conversations with some clients, it's still the right thing to do.

In a world where the best- and worst-performing asset classes tend to dominate the headlines, it's easy to lose sight of the fact that a diversified investment portfolio is generally the most reliable approach for meeting long-term investment objectives. Diversification is a time-tested component of portfolio construction, especially when looked at through the lens of risk-adjusted returns in terms of Sharpe ratios. Historically, the result is a less volatile portfolio that tends to produce something close to middle-of-the-road performance year in and year out. This is in contrast to the best- and worst-performing asset classes, which despite volatility in returns and market leadership often dominate the financial news headlines. Hence the sentiment that diversification is rather boring.

Diversification rarely wins in any given year

By design, a diversified portfolio is going to hold a mix of asset classes, some of which will outperform and some of which will underperform in any given year. As a result, a diversified portfolio will never beat the top-performing asset class in any given year, although it's notoriously difficult for investors to consistently pick which asset classes will perform best in any given year. For some investors, these results lack the appeal of high-flying tech stocks, rapidly rising emerging markets or other flavor-of-the month champions. This point of view arises from some well-known cognitive and emotional biases, which SEI has covered at length in its series of Behavioral Finance papers.

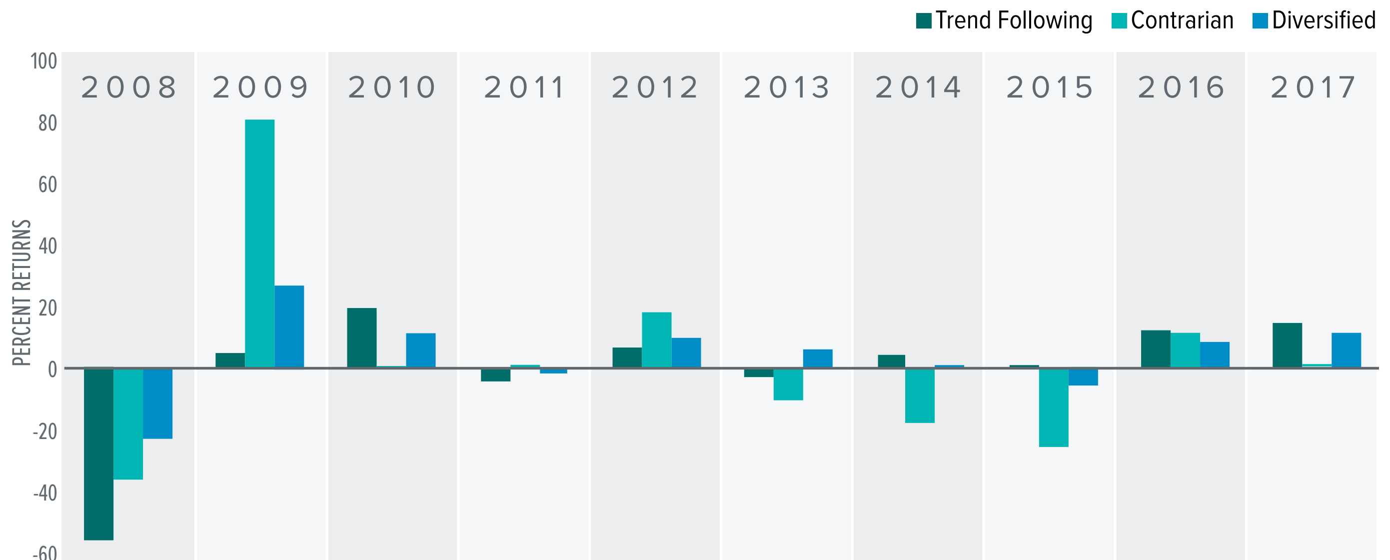
To counter this reality, we developed a framework that demonstrates the power of diversification. Consider three highly simplified investment strategies:

Trend Following: Each year, the Trend Following strategy invests only in the prior year's top-performing asset class.

Contrarian: The Contrarian invests in the prior year's worst-performing asset class.

Diversified: The Diversified strategy simply holds equal amounts of all available asset classes year in and year out.

Over the last 10 years, the Trend Following strategy would have beat the other two strategies 50% of the time. The Contrarian approach would have won in 30% of those years. And the Diversified approach would only have come out on top in two of those ten years.



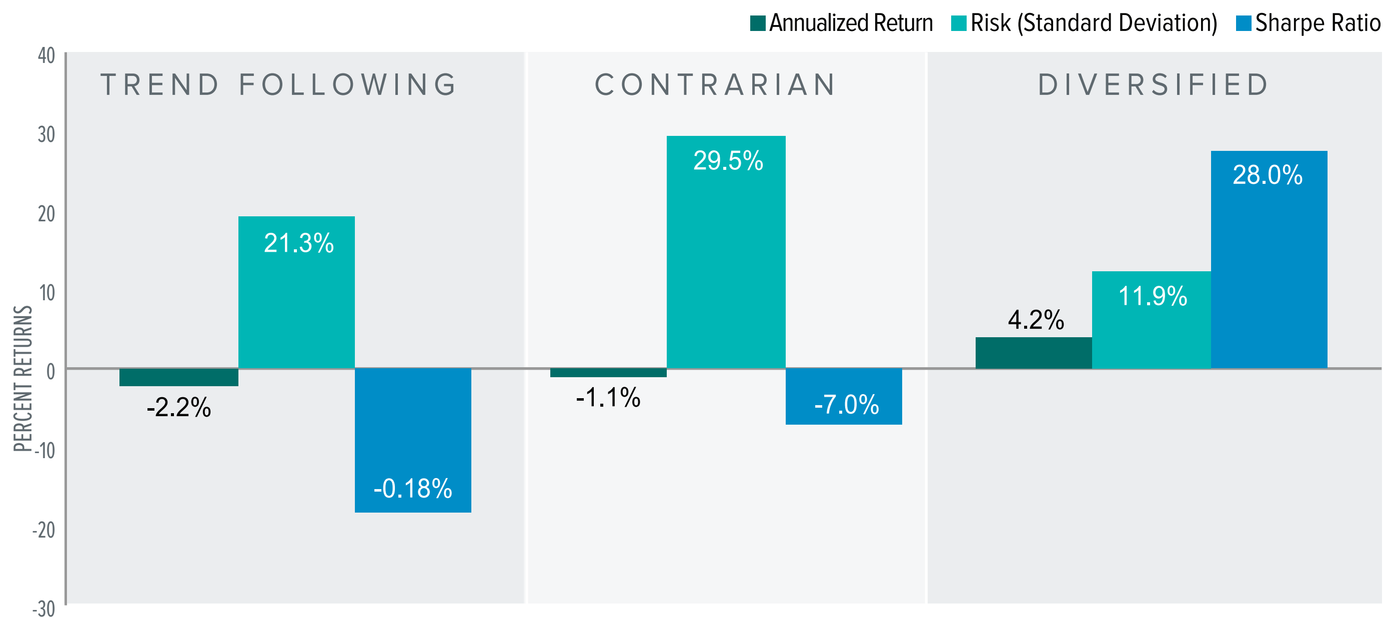
SOURCE: SEI/Bloomberg
Past performance is no guarantee of future results.

Diversification also rarely loses ...

We've already established that a Diversified strategy can't beat the top performing asset class in any given year, but by definition, it can't be the worst performer either.

In terms of risk-adjusted returns, diversification has won hands down over the past decade. While the Trend Following and Contrarian strategies would have produced negative returns overall with much higher volatility, the Diversified approach would have provided a respectable overall return with far less volatility and, as a result, much higher risk-adjusted returns. This is despite the Diversified strategy rarely being the top performer of the three strategies in any given year.

... And diversification wins over time



SOURCE: SEI/Bloomberg, 10 years as of 12/31/17.
Past performance is no guarantee of future results.

It's not always easy to do the right thing

What this tells us is that, while Trend Following and Contrarian strategies may offer a better chance of outperforming many asset classes and diversified portfolios, they are double-edged swords, because they also impose a higher probability of significantly underperforming. The relative stability conferred by a Diversified strategy may help to avoid significant losses in any given year while reducing the overall volatility of the investment experience. And portfolios that can avoid extreme losses while enjoying lower volatility tend to outperform in the long run. This is why we preach diversification; it may be boring but, as the past ten years illustrate, it has provided benefits that the other strategies discussed here have not.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
US Core Fixed 5.2%	Emerging Equity 78.5%	US Small Cap 26.8%	TIPS 13.6%	Emerging Equity 18.2%	US Small Cap 38.8%	US Large Cap 13.2%	US Large Cap 0.9%	US Small Cap 21.3%	Emerging Equity 37.3%
Short Duration 4.6%	US High Yield 58.2%	Emerging Equity 18.9%	US Core Fixed 7.8%	Int'l Equity 17.3%	US Large Cap 33.1%	US Core Fixed 6.0%	Short Duration 0.7%	US High Yield 17.1%	Int'l Equity 25.0%
Cash 3.8%	Int'l Equity 31.8%	Commodities 16.8%	US High Yield 5.0%	Emerging Debt 17.2%	Int'l Equity 22.8%	US Small Cap 4.9%	US Core Fixed 0.5%	US Large Cap 12.0%	US Large Cap 21.7%
TIPS -2.4%	US Large Cap 28.4%	US Large Cap 16.1%	Emerging Debt 2.8%	US Large Cap 16.4%	US High Yield 7.4%	TIPS 3.6%	Cash 0.2%	Commodities 11.8%	US Small Cap 14.6%
Emerging Debt -8.6%	US Small Cap 27.1%	US High Yield 15.1%	Short Duration 1.7%	US Small Cap 16.4%	Short Duration 0.6%	US High Yield 2.5%	Int'l Equity -0.8%	Emerging Equity 11.2%	Emerging Debt 12.7%
US High Yield -26.2%	Emerging Debt 26.0%	Emerging Debt 14.0%	US Large Cap 1.5%	US High Yield 15.8%	Cash 0.2%	Short Duration 0.8%	TIPS -1.4%	Emerging Debt 10.2%	US High Yield 7.5%
US Small Cap -33.8%	Commodities 18.9%	Int'l Equity 7.8%	Cash 0.3%	TIPS 7.0%	US Core Fixed -2.0%	Emerging Debt 0.7%	US Small Cap -4.4%	TIPS 4.7%	US Core Fixed 3.5%
Commodities -35.6%	TIPS 11.4%	US Core Fixed 6.5%	US Small Cap -4.2%	US Core Fixed 4.2%	Emerging Equity -2.6%	Cash 0.2%	US High Yield -4.5%	US Core Fixed 2.6%	TIPS 3.0%
US Large Cap -37.6%	US Core Fixed 5.9%	TIPS 6.3%	Int'l Equity -12.1%	Short Duration 1.3%	Emerging Debt -7.1%	Emerging Equity -2.2%	Emerging Debt -7.1%	Short Duration 1.3%	Commodities 1.7%
Int'l Equity -43.4%	Short Duration 5.0%	Short Duration 2.6%	Commodities -13.3%	Cash 0.5%	TIPS -8.6%	Int'l Equity -4.9%	Emerging Equity -14.9%	Int'l Equity 1.0%	Cash 1.1%
Emerging Equity -53.3%	Cash 1.0%	Cash 0.3%	Emerging Equity -18.4%	Commodities -1.1%	Commodities -9.5%	Commodities -17.0%	Commodities -24.7%	Cash 0.7%	Short Duration 0.9%

SOURCE: SEI/Bloomberg

Chart disclosures

Asset-class returns are based on the same indices as indicated below. Performance begins 1/1/2008 and continues through 12/31/2017. 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.

Definitions

Sharpe Ratio: A measurement of the reward per unit of risk, which is calculated by using standard deviation (risk) and excess return over a risk-free index.

Standard deviation: Statistical measure of historical volatility. A statistical measure of the distance a quantity is likely to lie from its average value. It is applied to the annual rate of return of an investment, to measure the investment's volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment's return will be. A standard deviation of zero would mean an investment has a return rate that never varies.

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, U.S. Core Fixed Income = Bloomberg Barclays U.S. Aggregate Bond Index, High Yield Bonds = BofA ML US High Yield Constrained Index, Emerging Debt = 50% JP Morgan EMBI Global Diversified Index and 50% JP Morgan GBI EM Global Diversified Index, TIPS = Bloomberg Barclays US TIPS 1-10 Year Index, Short Duration = Bloomberg Barclays Aggregate 1-3 Years 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.

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 Aggregate 1-3 Year Index is an unmanaged index that consists of publicly issued investment grade corporate, US Treasury and government agency securities with remaining maturities of one to three years. An investment cannot be made directly in an index.

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 JP Morgan Emerging Market Bond Index is a total return, unmanaged trade-weighted index for U.S. dollar denominated emerging-market bonds, including sovereign debt, quasi-sovereign debt, Brady bonds, loans and Eurobonds.

The JP Morgan 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 1000 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 2000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the Funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts. There is no assurance as of the date of this material that the securities mentioned remain in or out of SEI Funds.

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Diversification may not protect against market risk. There is no assurance the objectives discussed will be met. Past performance does not guarantee future results Index returns are for illustrative purposes only and do not represent actual portfolio performance. Index returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index.

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