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In 2016, Diversification Matters

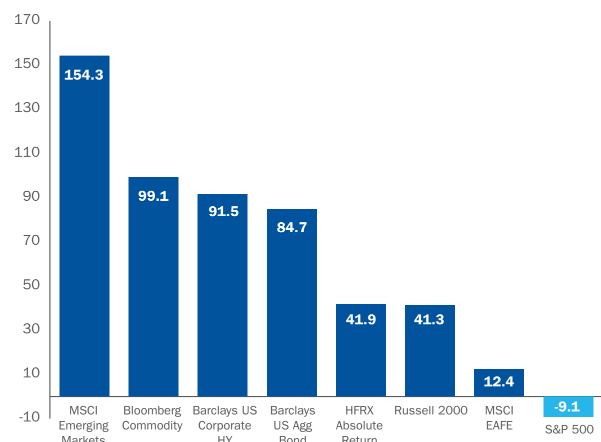
Over the past few years, diversified portfolios have posted only modest results, as they struggled to keep pace with the more narrowly focused but high profile large-cap domestic equities. However, four months into 2016 has shown that diversification may still be beneficial. Several asset classes that struggled the past few years have finally shown some life, leading markets higher and underscoring the advantages of diversifying your asset allocation. Markets started the year with a strong pullback, as the S&P 500 posted its worst 10-day start of a year on record. The decline lasted until mid-February, highlighting the downside protection benefits of alternative asset classes. Since that point, markets have experienced a strong rally on the back of dimensions that have been out of favor over the past year, including small caps, value-oriented assets and emerging markets, an asset class which has generated particularly poor performance over the past few years.

Through the first four months of 2016, the MSCI Emerging Markets Index is up 6.3%, compared with 1.7% for the S&P 500. The long-awaited rotation from growth into value has emerged quickly this year. The performance difference between the Russell 1000 Growth and the Russell 1000 Value indices reached 400 bps at month end, from -0.2% to +3.8%, respectively, for the first four months of 2016. The difference between small cap is even wider: +3.9% for the Russell 2000 Value, and -3.7% for the Russell 2000 Growth. Even commodities, which have been the most out-of-favor asset class of the past few years, managed to post a strong return of 9% through April.

The potential benefits of diversification were also on display within fixed income sectors. While the Barclays U.S. Aggregate Bond Index is up a respectable 3.4% during the first four months of the year, global fixed income and high yield both posted even stronger results. The Barclays Global Aggregate gained 7.3% through April, and the Barclays U.S. Corporate High Yield posted a gain of 7%, both of which were more than double that of the Barclays U.S. Aggregate Bond Index.

Strategic-minded investors often need a refresher course on past results to remind them of the merits of diversification. We don't have to go too far back in time to find an extended period in which diversifying asset classes provided real strength. In the decade from January 2000 to the end of 2009, U.S. stocks struggled. The S&P 500 posted a total return loss of -9.1%, compared with a gain of +154.2% for the MSCI Emerging Markets and an advance of 84.75% for the Barclays Aggregate Bond Index. Despite the weakness in the U.S. economy (and bookended by recessions), Russell 2000 small cap stocks posted a 41% gain, and the commodities sector gained 99%. It was the worst 10-year stretch in the S&P 500's history, including the 10 years surrounding the Wall Street Crash of 1929.

A Lost Decade for U.S. Stocks: 2000–2009 Returns



Source: Morningstar

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In this article, we examine several areas of the market that have lagged, and highlight why investment allocations to these areas maybe important components of a diversified portfolio. In continually reviewing and analyzing our performance, we realize that there will be times over the short term that diversified portfolios may underperform based on results of positioning across multiple asset classes. Strategic investors not only need to understand the current environment but also compare it to other time periods, in which the case for diversification may be more obvious.

Commodities

A commodities allocation can be an inflation hedge and a risk diversifier from equities and fixed income. Commodity performance has struggled, as fears of a global demand slowdown have affected negatively both energy and precious metals prices. Despite the weak performance over the past few years, we believe than an allocation to commodities may make sense for many clients. In the 15 full calendar years from 2000–2014, inflation has exceeded 3% in four of them. In those years, the S&P GSCI TR (Commodity Index) rose an average of 31%. Since 1971, there have been 25 years in which inflation was above 3%, and commodities had negative performance in only four of those years. Although inflation now is somewhat muted, the U.S. and global central banks have exerted significant monetary efforts to sustain economic growth, a factor that could have inflation implications going forward. Commodities can be highly volatile, but in certain years, like 2000 and 2002, they have been a top-performing asset class. As global demand starts to pick up, commodities are likely to come back in favor, and prices should appreciate.

Emerging Markets

Emerging markets are one of the key drivers of the global economy, and an allocation to the asset class is in line with a long-term strategic positioning. Weakness in global growth has put significant downward pressure on returns in emerging markets countries, with a notable drop in earnings. Even small exposures to the asset class have hurt portfolio performance the past few years. However, in 2016 emerging markets have served as a performance driver for portfolios with exposure to the asset class. In the first quarter, several emerging markets did well, with the MSCI Latin America and MSCI EM Eastern Europe indices posting advances of +19.1% and +15.0%, respectively. Higher commodity prices, combined with an improving investor risk appetite and dovish global central banks, helped to fuel much of the rally this year.

Even though emerging markets struggled in 2013–2015, the asset class was a top performer in calendar years 2007, 2009, and 2012. In fact, it is not uncommon for emerging markets to have periods of strong outperformance. Many emerging markets countries are growing at rates higher than the U.S. They also are at varying points in their economic cycles, which can provide additional sources of return and diversification. Although emerging markets equities face potential headwinds, including geopolitical risk in Eastern Europe and the Middle East, we believe they will continue to be a driver of global growth.

International Equities

International equities provide investors an opportunity to benefit from a global economy. After a strong first half in 2015, international equities reversed course during the third quarter last year, and underperformed relative to domestic equities closing out 2015. Valuations of non-U.S. developed equities have fallen over the past few years, increasing their discount to historical averages, and now trade at a discount relative to their U.S. peers. Notwithstanding these lower prices, fears of a continued slowdown in Europe and Asia have hurt performance. But, the global economic backdrop has shown some signs of improvement, and foreign economies are set to benefit from weaker currencies, lower inflation rates, and accommodative monetary policies. Although there are risks of recession and anemic growth in Europe, international equities' relative value offers a potential benefit to portfolios with an objective of generating long-term results. Through the first four months of 2016, the MSCI EAFE is roughly flat and slightly behind its U.S. peers.

Fixed Income

As an equity diversifier, fixed income limits some of the downside when compared with an all-equity strategy. Within typically more conservative models, the larger allocation to bonds has helped add to gains this year, as fixed income has outperformed equities through the first four months of 2016. Thus far in 2016, a flight to safety sent Treasury yields lower. Yield curves have flattened, and longer duration bonds have outperformed. High yield bonds bounced back in March after a poor start to the year. The Barclays U.S. Corporate High Yield index is up 7.4% through the first four months of the year.

We maintain that a diversified bond allocation is a critical part of a balanced portfolio. Within fixed income, certain sectors may have credit, interest rate, and liquidity risks. Although U.S. investment grade has limited credit risk, its interest rate sensitivity is high. High yield and global

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fixed income may have struggled recently, but with the prospect of rising U.S. interest rates in the near future, diversifying that risk is important. Even in today's extended low interest rate environment, we have seen strong performance from fixed income asset class diversification, and believe that portfolios should retain exposure to the asset class.

Liquid Alternatives

Liquid alternatives positioning is designed to reduce risk by taking advantage of the asset class's low correlation to more traditional stock and bond allocations. Designed to mitigate risk, many of these strategies can boost performance when markets are either volatile or falling. Exposure to this asset class on the equity side helped to offset losses from the broad-based equity selloff.

Through the mid-February market pullback, the need for liquid alternatives and downside protection was apparent. In reviewing 2008 (the most-recent and longer period of volatility), the MRFX Merger Arbitrage Index was up 3.7%, and the HFRX Absolute Return Index declined -13%, compared to a -37% drop in the S&P 500. In a challenging market environment, we expect an alternatives exposure to outperform by improving the portfolios' risk profile and greatly increasing its diversification.

So, Does Diversification Still Matter?

Although some may question the value of diversification in the market environment of the past few years, which mostly has rewarded U.S. large cap stocks, a closer look across other market cycles highlights its importance. Performance in 2016 has illustrated the value of diversification and the benefits for a balanced approach to portfolio management.

History has shown that over shorter time periods, different asset classes will outperform as others lag. In the three-year rolling periods of 2005–2007 and 2001–2003, international stocks outperformed the S&P 500, comprising domestic large caps stocks. Commodities also performed well during both periods. High yield outpaced the Barclays U.S. Aggregate Bond Index over all three periods; supporting the case that diversifying within fixed income has the potential for outperformance. Even though diversification may not always benefit portfolios over the short term, we maintain that it is a much more prudent option for portfolio management than relying on market timing to rotate in and out of asset classes. Market timing is seldom effective, and often can lead to disastrous results in which investors actually buy high and sell low.

	1/1/2013 12/31/2015 (Annualized)	1/1/2005 12/31/2007 (Annualized)	1/1/2001 12/31/2003 (Annualized)
S&P 500	15.1	8.6	-4.1
Russell 2000	11.7	6.8	6.3
MSCI EAFE	5.0	16.8	-2.9
MSCI Emerging Markets	-6.8	35.2	12.5
Bloomberg Commodity	-17.3	12.9	7.9
Barclays US Agg Bond	1.4	4.6	7.6
Barclays US Corporate HY	1.7	5.4	10.2

Source: Morningstar

When constructing portfolios with a long-term strategic view, combining multiple asset classes that have low correlations to one another has shown to be a pragmatic investment practice. Diversification allows portfolios to enhance long-term return potential without assuming undue risk. Although recent years have not made a strong case for diversification, we contend that the long-term results demonstrate its success, and may reward those investors who adhere to its tried and tested practice. Diversification has been referred to as the only "free lunch" in investing, and we believe that a diversified portfolio rebalanced periodically is an excellent way for investors to achieve their investment objectives.

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