Rumors of the Death of Diversification are Greatly Exaggerated…Again
Tracie McMillion, CFA®, Head of Global Asset Allocation
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In the late 1990s, few of our clients were interested in investments outside of U.S. large-cap stocks. Some wanted to narrow their portfolios to hold only growth or even technology stocks exclusively. At the time, diversifying into other sectors and asset classes seemed like a drag on performance. In general, investors did not want “to settle” for the subpar returns they expected from other asset classes, like bonds and international stocks. For example, in 1998 the S&P 500 Index returned more than 28 percent while bonds returned a relatively paltry 9.5 percent and cash ONLY returned 5.2 percent. Even worse, emerging market equities suffered an appalling 25 percent loss that year, a full 53 percent lower return than the S&P 500 Index.

Building the case for diversifying
What many successful investors understood back in the late 1990s, however, was that reducing downside risk through diversification can help to produce better results over time as markets cycle through the emotions of fear and greed. After two of the largest market downturns in history and more than a decade of underperformance, the S&P 500 Index has outperformed nearly every other asset class over the past two years, and the benefits of diversification are being called into question again. To help illustrate why we believe a diversified portfolio is still appropriate for most investors, we created the following chart showing the growth of $100 invested in a variety of different asset types over a 15-year period.

Chart 1: 15 Year Cumulative Performance (January 2000- December 2014)

Hypothetical Benefits of Diversification and Rebalancing


Looking at this chart, which path would you have chosen for your portfolio over the past 15 years? The most lucrative choice is represented by the green line, but it is also the most volatile. Many investors would not have been able to withstand the 60
percent drop the green line experienced in 2007 and 2008 when it fell from a value of over $350 dollars to just above $100 dollars before rebounding. The choice most people would probably make is the smooth gold line that represents the third-most lucrative option. In addition, the silver line has exhibited a modest level of volatility and, at the same time, performance is very good relative to the other lines.

Now consider one more line—the dark blue line in the chart below. Given this new choice—not quite as smooth as the light blue line, but still relatively stable and now the second-most lucrative choice—many investors would probably select the dark blue path.

**Chart 2: 15 Year Cumulative Performance (January 2000- December 2014)**

*Hypothetical Benefits of Diversification and Rebalancing*

The returns shown in this example are actual asset classes and the new dark blue line is a combination of all the asset classes shown (and several others). In other words, the dark blue line represents a diversified portfolio and shows how diversification can work over a longer period of time.
But what about that smooth gold line, why not just pick that path since the final return is so consistent? The answer is in the future expectations we have for that brown line. It represents a domestic bond portfolio, and we believe U.S. bonds are likely to experience lower returns in the years to come as we expect interest rates to rise and bond prices to fall.

What about the silver line? It is nearly even with the bond portfolio and, at many times over the years, it has exceeded the bond portfolio and the diversified portfolio. Furthermore, when we look at a chart showing volatility, as represented by standard deviation, the silver line (which represents hedge funds) stands out as a very steady asset class.
Indeed, hedge funds in addition to bonds, can provide some stability to an overall portfolio, but should not be a standalone investment due to the unique risks—beyond volatility—that hedge funds can exhibit. Similarly, using any single asset class (or even asset group) greatly increases the risk that you will not reach your longer-term financial goals. Instead, we believe employing the different characteristics of multiple asset classes through varying market cycles is the key to reaching those goals.

Since the financial crisis
In 2007 and 2008, the global economy suffered the worst financial crisis since the great depression. Since then, the S&P 500 Index has moved ahead of the diversified portfolio and a bond portfolio, but with greater volatility. Over the same period, international markets, hedge funds and commodities have fallen behind.

Chart 5: Five Year Cumulative Performance (January 2010- December 2014)

Hypothetical Benefits of Diversification and Rebalancing

Source: FactSet, February 2015. Please see Disclosures for full definitions.

Does that suggest that now is the time to exit these other asset classes? Not necessarily. Diversification is like a form of insurance against downturns in the market. Insurance has a cost and the cost here is temporary bouts of underperformance vs. relatively narrow benchmarks, such as the S&P 500 Index. In years like 2013 and 2014, in which there are a number of significant transformations occurring in the global financial markets, we would expect balanced portfolios to underperform our longer-term capital market assumptions. Over the long-term, however, our strategic allocations appear on track to meet those expectations.

A diversified portfolio invariably will underperform some of its components, and last year was no exception. However, as the chart below illustrates, there is no way to know in advance which asset classes will rise to the top of the group in any given year.
What is important for investors is that they: build an investment strategy that addresses specific investment needs; maintain adequate liquidity to ride through short-term market turmoil; and match the time horizon of their investments with the time horizon of their financial goals. These three considerations are often forgotten, and during times of greed, investors may stretch their investment horizons, while in times of fear their investment horizons may shrink to cash. Such an approach can lead to very unsatisfactory results. Instead, we suggest you consider building a global asset allocation, and rebalancing it on a regular basis.

Through market cycles when specific assets may be over or under valued, rebalancing forces the discipline of buying risk when it is cheap and selling risk when it is expensive. In other words, buy low and sell high. And finally, don’t let short-term emotions enflamed by a provocative media deral your disciplined investment strategy. There are many examples of investors timing in and out of the markets, or jumping on the theme of the day only to be caught on the wrong side of a market move. At any point in time one asset class will be out performing all others. That does not mean you should scrap your diversification strategy and go all in. Time and time again, investors fall into that trap. In our opinion, asset allocation is the best way to capture the upside potential of the full investment spectrum through the ups and downs of market cycles.

Data for this report was sourced from Bloomberg Finance, LLP, unless otherwise noted.
Disclosures

Important risk disclosures:

All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security. Equity securities are more volatile than bonds and subject to greater risks. Bonds are subject to interest rate, price and credit risks. Prices tend to be inversely affected by changes in interest rates. Investments in foreign securities entail special risks such as currency, political, economic, and market risks. These risks are heightened in emerging markets. Investing in commodities is not suitable for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Asset class risks

Commodities: Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies, which may expose investors to additional risks.

Equity investments: Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.

Fixed income: Investments in fixed-income securities are subject to interest rate and credit risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. Government bonds are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although government bonds are considered free from credit risk, they are subject to interest rate risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Foreign investments: Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Hedge funds: Hedge funds are complex, speculative investment vehicles and are not suitable for all investors. They are generally open to qualified investors only and carry high costs and substantial risks and may be highly volatile. There is often limited (or even non-existent) liquidity and a lack of transparency regarding the underlying assets. They do not represent a complete investment program. The investment returns may fluctuate and are subject to market volatility so that an investor’s shares, when redeemed or sold, may be worth more or less than their original cost. Hedge funds are not required to provide investors with periodic pricing or valuation and are not subject to the same regulatory requirements as mutual funds. Investing in hedge funds may also involve tax consequences. An investment in a hedge fund involves the risks inherent in an investment in securities as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-U.S. securities, “junk” bonds, and illiquid investments. There can be no assurances that a manager’s strategy (hedging or otherwise) will be successful or that a manager will use these strategies with respect to all or any portion of a portfolio.

Real estate: There are special risks associated with an investment in real estate, including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Small- and mid-cap companies: The prices of small- and mid-company stocks are generally more volatile than large-company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions.

Allocations and important definitions

Balanced Portfolio (4A BP) = 3% Barclays US Treasury Bill 1-3 Months, 19% Barclays US Aggregate Bond Index, 5% Barclays US Corporate High Yield Index, 5% JPM GBI Global Ex-US TR USD Index, 4% JPM EMBI Global TR USD Index, 16% S&P 500 Index, 7.6% Russell Mid Cap TR USD Index, 3.8% Russell 2000 TR USD Index, 9% MSCI EAFE GYI USD Index, 6.6% MSCI EM USD Index, 7% FTSE EPRA/NAREIT Developed TR USD Index, 4% Bloomberg Commodity TR USD Index, 2% HFRI Relative Value Arbitrage Index, 2% HFRI Macro Index, 5% HFRI Event Driven Index, 3% HFRI Equity Hedge Index.

An index is unmanaged and not available for direct investment.

Inflation is the change in the Consumer Price Index (CPI). The CPI measures the price of a fixed basket of goods and services purchased by an average consumer. Real economic growth is the change in the gross domestic product (GDP) adjusted for inflation—that is, the volume of services and goods produced in the United States.
Barclays U.S. Aggregate Bond Index is composed of the Barclays U.S. Government/Credit Index and the Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

Barclays U.S. Corporate High-Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

Barclays U.S. Treasury Bills (1-3M) Index is representative of money markets.

The Barclays Municipal Bond Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, and a remaining maturity of at least one year. The Index excludes taxable municipal bonds, bonds with floating rates, derivatives, and certificates of participation. The Barclays 10-Year Municipal Bond Index is the 10 Year (8-12) component of the Municipal Bond Index.

Bloomberg Commodity Index is a broadly diversified index of commodity futures on 20 physical commodities, subdivided into energy, U.S. agriculture, livestock, precious metals, and industrial metals sectors. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

BoFA Merrill Lynch Global High Yield & Emerging Markets Index tracks the performance of the below investment grade global debt markets denominated in the major developed market currencies.

Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

Dow Jones–UBS Commodity Index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. The index is composed of futures contracts on 19 physical commodities. No related group of commodities (e.g., energy, precious metals, livestock, and grains) may constitute more than 33 percent of the index as of the annual reweightings of the components. No single commodity may constitute less than two percent of the index.

FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

FTSE NAREIT Equity REITs Index includes all REITs that trade on the New York Stock Exchange, American Stock Exchange and NASDAQ National Market list, and is considered representative of the equity REIT market.

The HFRI Indices currently consist of eight single strategy indices, an asset-weighted Global Hedge Fund Index, and HFRI Equal Weighted Strategies Index, each calculated pursuant to an index methodology. Most HFRI Indices are priced daily. All HFRI Indices are re-balanced quarterly.

HFRI Relative Value Index maintains positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types.

HFRI Equity Hedge Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Macro Index is composed of a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods. Although some strategies employ RV techniques, macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than realization of a valuation discrepancy between securities.

HFRI Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is composed of eight strategies: convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.

HFRI Event Driven Index maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance, or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Event driven exposure includes a combination of sensitivities to equity markets, credit markets, and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative) with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.
JP Morgan Global Ex United States Index (JPM GBI Global Ex-US) is a total return, market capitalization weighted index, rebalanced monthly, consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.

JPM EMBI Global Index is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed-market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

MSCI All Country World ex U.S. Index (MSCI AC World Ex U.S.) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the U.S. The index consists of 45 country indices comprising 22 developed and 23 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI EAFE Index (Europe, Australasia, Far East) Index (MSCI EAFE NR) is a free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The index consists of the following 21 developed-market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI Emerging Markets Index (MSCI EM NR) is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. The index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

MSCI Frontier Markets Index consists of 22 countries tracking the performance of a range of equity markets that have become accessible to global investors.

NAREIT Global Real Estate Index measures the performance of listed real estate companies and REITs worldwide, the series acts as a performance measure of the overall market.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock’s weight in the index proportionate to its market value.

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