THE GLOBE AND MAIL
GLOBEINVESTOR MAGAZINE

Globe Investor Magazine Online, July 21, 2009

# Portfolio diversification failure puts risk under spotlight

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*Market turmoil has caused investment professionals to rethink their investment approach.*

The past 12 months have been a humbling experience for investment industry practitioners and academics alike, causing a fundamental re-examination of core beliefs underpinning their approach to investing.

Among the casualties were some of the industry's smartest minds who had constructed portfolios on the principle that diversifying in global stocks, real estate, private equity and commodities would protect them from steep declines. But the only investments that held their value last year were cash, precious metals and government bonds.

The theoretical underpinning for diversification comes from U.S. economist Harry Markowitz, father of the modern portfolio theory for which he won the 1990 Nobel Prize in economics.

Entire careers have been built on his work. The poster child for sophisticated application of the principles of diversification is David Swensen, who left a career on Wall Street to head up Yale University's endowment fund. Over a 20-year period going into last spring, Yale averaged a return of 16 per cent, more than any other large endowment or pension fund.

Mr. Swensen did this by de-emphasizing the lower returns on bonds in favour of better returns from equity ownership, going beyond stocks to invest in private equity, hedge funds, venture capital, real estate and direct ownership of income-generating vehicles such as oil, gas, timber and infrastructure.

His success influenced other university endowments and pension funds such as Ontario Teachers, the Canada Pension Plan and Quebec's Caisse de dépôt et placement du Québec to look for diversified investments beyond stocks and bonds.

The essence of effective diversification is combining assets that behave differently so that when one falls, the other rises, so-called “non-correlated” assets. That worked well until last year; in the 12 months ended in June, endowment funds such as Harvard and Yale were down as much as 30 per cent, resulting in unprecedented cutbacks in staff and university spending.

A key lesson from the downturn is that in declining markets, finding non-correlated assets is much harder than was thought. A study recently presented to the Chartered Financial Analyst Institute shows that diversification across asset classes works in rising markets but fails in falling markets. The reason, according to the authors of the study, is that “fear is more contagious than optimism.”

Twelve months ago, many believed that major economies such as the United States, Europe, China and India were sufficiently strong, that “decoupling” had taken place: Problems in one region would not necessarily drag others down. The past year reminds us that it's still very much a global world; when one major region suffers severe problems, a “contagion” effect takes place that inevitably spreads elsewhere.

Some thought that owning both value and growth stocks and a variety of large and small stocks would offer protection, but all stocks went down. And the credit crunch meant that prices of corporate bonds dropped sharply, in tandem with their underlying stocks.

Some would conclude from this that investors should give up on diversification, but that would be taking entirely the wrong lesson from the year's events.

At a recent Morningstar conference, a keynote speaker pointed out that in 2008, one in four U.S. stocks suffered a decline of 75 per cent or more. By contrast, out of 15,000 non-levered U.S. mutual funds (funds that didn't borrow to increase investor returns), only one suffered a similar loss. This means that diversified holdings dramatically reduced the risk of the catastrophic loss of three-quarters of a U.S. portfolio from 25 per cent to almost zero.

It's not that diversification failed. It's just that it didn't shelter portfolios to the extent expected in a specific period.

Perhaps the most important lesson from last year is that investors need to better understand the limitations of diversification as a buffer from short-term market declines. There is always near-term risk associated with anything offering returns above the guaranteed level available in GICs or short-maturity government bonds.

There's every reason to believe that the underpinnings of diversification will still deliver better returns and lower risk over time. But we were reminded that just because something will be true over 20, 10 or five years doesn't mean it will be true over one year.

Investors have to examine how much short-term volatility they can live with. A year ago, conventional wisdom was that you should be prepared for a one-year decline of 30 per cent in the stock component of your portfolio; today, that number has to be adjusted upward to a possible decline of 50 per cent.

For investors who can't live with this, it will mean saving more, retiring later or scaling back their retirement lifestyle.

And for investors in retirement, it might also mean holding more assets in cash or cash equivalents, so they're able to ride out an extended period of downward performance without being forced to sell investments at depressed prices.

A clearer picture of the benefits of diversification will lead to more realistic expectations and portfolios that are better suited to investors' tolerance for risk – leaving them less exposed to unpleasant surprises and better off, as a result.

*Special to the Globe and Mail*