RAYMOND JAMES | MUTUAL FUND RESEARCH

EYE ON THE MARKET

Diversification: Eggs, Baskets, & All the Kings Men

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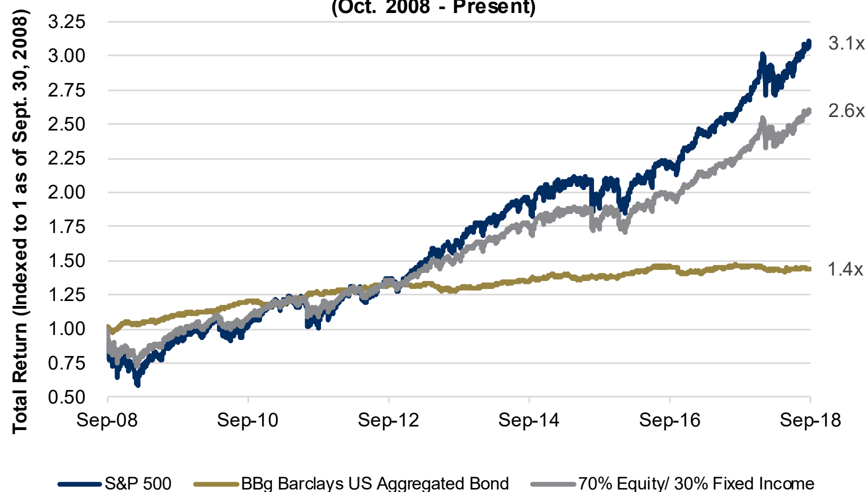
Eye on the Market ("EotM") believes that investors should live by the adage of "not keeping all of their eggs in one basket". If an investor had her nest egg concentrated in a single security, it would be a positive experience if the security performed well over time. However, if broad market or security-specific sentiment turns negative, she would have no buffer to offset her losses. By owning multiple baskets of securities across uncorrelated assets, our investor's nest egg would be diversified, allowing her to reduce her overall risk profile. While there are no guarantees in investing, having a diversified portfolio should reduce the overall risk of the portfolio.

OVER EASY OR SCRAMBLED

Over the last decade, the S&P 500 rose significantly after emerging from the depths of the financial crisis. In fact, it has generated a cumulative total return of nearly 310%. In other words, an investor would have tripled his initial investment since the trough in 2008. This has been an extraordinary rally for U.S. large-cap equity investors.

Chart 1



Source: Raymond James Morningstar Direct

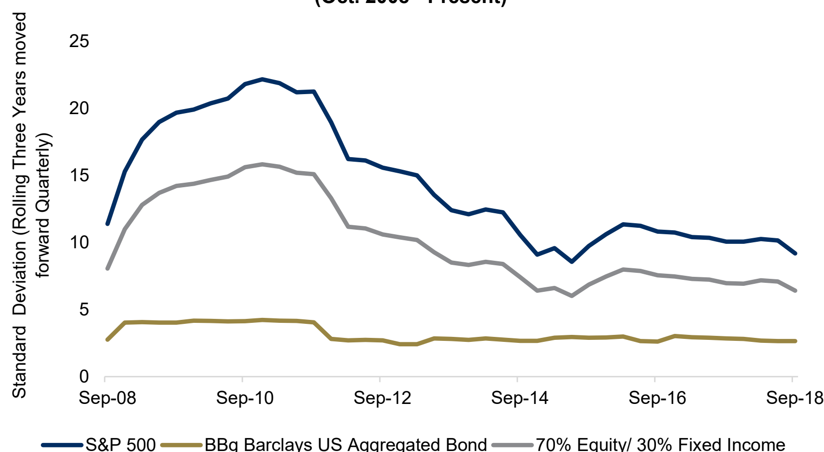
That being said, an allocation to 70% equity and 30% fixed income, using the S&P 500 and the Bloomberg Barclays U.S. Aggregate Bond Indexes as proxies, would have resulted in an a cumulative total return of 260%. By diversifying the portfolio to include fixed income, the investor was still able to capture nearly 84% of the total returns of the equity-only allocation. By adding fixed income, one of the most effective "equity-risk mitigators," the investor did not forgo a meaningful portion of the total return (as illustrated in Chart 1).

MORE THAN A CARRYING VESSEL

As Chart 2 shows, an investor would reduce their risk, as measured by standard deviation, simply by adding an allocation to fixed income. Does this imply that an investor should only have two asset classes in her portfolio? Not necessarily, but it does serve to illustrate that diversification can help reduce overall portfolio risk if the appropriate asset classes are optimally positioned.

An investor can add a wide variety of asset classes to a portfolio to create diversification benefits. Investors should also consider drilling down even further into the various sub-asset classes that can provide additional diversification benefits, but to a lesser extent. Sub-asset classes include market capitalizations, geographies, investment styles, and portfolio managers.

Chart 2



Source: Morningstar Direct and Raymond James

WHAT GOES UP, DOES COME DOWN!

While we have addressed “market math” in the past, EotM will provide a brief refresher, especially on the background of risk and portfolio diversification. Yes, a concentrated portfolio will likely perform better when that asset class is in favor. On the other hand, when an asset class falls out of favor, having a high concentration can be problematic. In the hypothetical illustration shown on Chart 3, both portfolios declined during year one. The big difference is that during the second year, the concentrated portfolio would need to appreciate by nearly 100% just to return to its starting level. The diversified portfolio declined less, and therefore had less ground to make up.

Chart 3

Hypothetical Illustration					
	Initial Investment	Year 1 Performance	End Balance	Year 2 Performance	End Balance
Diversified Portfolio	$10,000	-25%	$7,500	33%	$10,000
Concentrated Portfolio	$10,000	-50%	$5,000	100%	$10,000

This chart is for illustrative purpose only and is intended to demonstrate the mathematical principles of recovering from a drawdown. It does not reflect the performance of any investment.

PICKING UP THE BITS AND PIECES

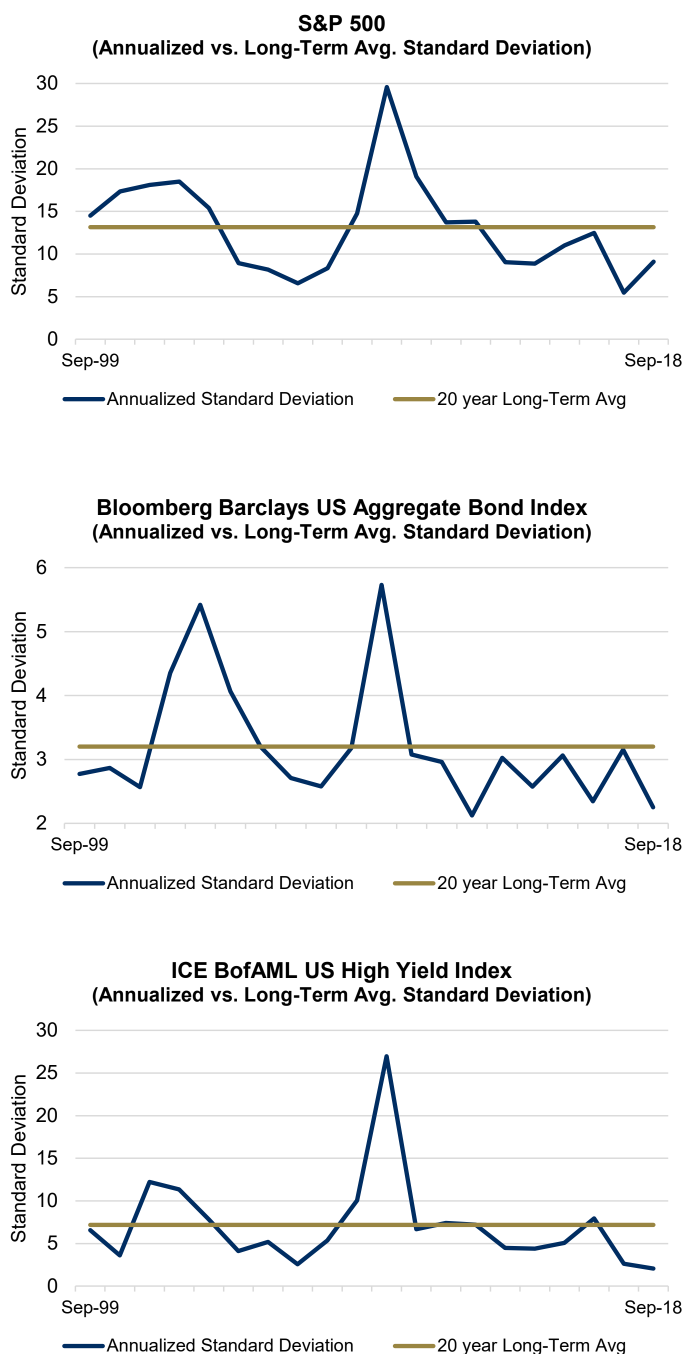
Had Humpty Dumpty appreciated the risks of sitting on the wall, he likely would not have fallen. In a similar manner, investors should periodically revisit their asset allocations and risk exposure to assure they are properly positioned to weather a negative market event.

The current market environment is a particularly good time to review your risk profile since the market experienced a decade of strong growth. As Chart 4 highlights, the annualized standard deviation for the S&P 500, Bloomberg Barclays U.S. Aggregate Bond, and ICE BofAML U.S. High Yield Indexes are all below their respective 20-year average.

EotM wants to remind readers this subdued volatility over the last few years is atypical. As indicated on Chart 4, the S&P 500 and the ICE BofAML U.S. High Yield had very comparable levels of volatility in their returns during the peak of the financial crisis whereas the Bloomberg Barclays U.S. Aggregate Bond Index displayed much lower levels of volatility.

Furthermore, the most recent level of volatility exhibited by the high yield index is only 30% of its 20-year average. Investors should remember that all asset classes have an underlying level of risk. When investors fail to remember this and become complacent, the outcome is usually unfavorable. One way of mitigating this is by combining uncorrelated asset classes to diversify overall portfolio risk exposure and return potential.

Chart 4



Source: Morningstar Direct and Raymond James

SIDE NOTE

The Beatles' "White Album" will turn 50 years old on November 22, 2018. The album's only cover image was the band's name, hence the "White Album." The Recording Industry Association of America indicates that the album is 19 times platinum (platinum indicating that 1,000,000 million units were sold). For those who did not purchase it upon initial release or via a streaming service, there will be a 50th anniversary release of the album.

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Definitions
S&P 500 Index is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market.
The Bloomberg Barclays U.S. Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and nonconvertible investment grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity.
The ICE BofA Merrill Lynch U.S. High Yield Index tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

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