Revisiting Diversification as "diworsification"

If we are taught one thing from the investment management industry, it is that increasing diversification is almost always beneficial. The claim is that you should hold commodities, bonds, real estate, etc. for your portfolio to represent just about every asset class that makes up the total wealth of the world.

Many investors and even some in the financial industry think that good diversification merely involves blindly putting money into a bunch of different assets and asset classes. But effective diversification has little to do with simply owning a lot of assets. Rather, effective diversification involves carefully selecting your assets in a way that manages and mitigates the various risks to which an investor is exposed.

For example, imagine a portfolio composed of Exxon stock, Chevron corporate bonds, Russian rubles (currency), an energy sector fund, and Dubai real estate. It is diversified across a wide array of asset classes – stocks, bonds, real estate and currency. However, it's not diversified *effectively* as it fails to consider one major risk factor, the price of oil. All of those different assets could be highly vulnerable to a decline in oil prices like the one we experienced in 2014.

While the previous example may seem extreme, intelligent investors can unwittingly fall into the same trap. For example, utility company stock prices have been moving closely in sync with long-term U.S. Treasury bonds recently. Over the past year, there has been an 81% correlation between these two assets[1]. One factor is that utility companies often have high costs of installing infrastructure and they finance it by maintaining large debt loads. When interest rates rise it becomes more expensive to finance debt, so the prices of many utility company stocks fall when interest rates increase. For a different reason we won't delve into here, Treasury bonds are also highly sensitive to movements in interest rate prices and their prices fall when interest rates increase. As a result, a portfolio which is concentrated in utility stocks and Treasury bonds, two traditionally popular asset classes, may have limited diversification benefits since both asset classes are exposed to significant interest rate risk. That's not to say that there's no benefit to owning those two assets together, but rather that it's important to recognize the limits of diversification.

Effective diversification may consider factors other than what's in your bank and brokerage accounts. For an example let's consider Enron, the energy company that declared bankruptcy following massive fraud by its top management. Many Enron employees at the time had large positions in Enron stock in their retirement plans[2]. When the company collapsed, the stock price fell more than 99%. Those same employees not only lost their jobs, but the value of their retirement assets plummeted in price at the

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worst possible time. In other words, they weren't properly diversified and instead were overly exposed to the performance of the company.

Diversification can be a powerful and effective tool for managing risk and protecting your assets, but diversification just for the sake of diversification adds little benefit. Improper diversification can even be harmful as it obscures risks behind an excessive amount of holdings which add no benefit to your portfolio.

It is also important to note that because the relationships between different assets change over time, the benefits of diversification also change over time. As the world becomes economically integrated, international stocks as a whole have become less effective as a diversification tool than they were a decade ago and the same could be said about commodities[3,4].

We monitor the dynamic relationships among various asset classes with the goal of adapting to the changes in these relationships that may threaten your portfolio. That is one way we attempt to add value to your financial life. Diversification is sometimes presented in an oversimplified context. Proper diversification may appear complex, but we utilize our disciplined, evidence-based research and tools to evaluate those risks. We also strive to avoid unnecessary diversification that adds excessive complexity with no benefit for risk reduction.

Please feel free to call us with any questions regarding the issues discussed in this letter or any other financial matters on your mind.

My very best,

Derrick

[1] The price of the iShares 20+ Year Treasury Bond ETF is used as a proxy for long-term Treasury bonds; the Utilities Select Sector SPDR® Fund is used as a proxy for utility company stocks. Correlation was measured using daily closing prices between June 2nd, 2014 and June 1st, 2015.
[2] http://www.nytimes.com/2001/11/22/business/employees-retirement-plan-is-a-victim-as-enron-tumbles.html.
[3] International Monetary Fund (2015). "April 2015 Global Financial Stability Report: Enhancing Policy Traction and Reducing Risks".
[4] Goetzmann, William, Linfgei Li, and K. Geert Rouwenhorst (2005). "Long-Term Global Market Correlations". *The Journal of Business*, Vol. 68 (1): 1-38.
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