COLUMBIA THREADNEEDLE INVESTMENTS

The disappointment of diversification

November 19, 2018

Concentration, not diversification, has been rewarded for most of 2018. A metric you've probably never heard of helps give some insight.

Diversification is one of the guiding principles of portfolio construction, but year-to-date market performance (especially prior to the October correction and the midterm elections) has undermined this well-established approach. The portfolios that have been rewarded as of late are U.S. portfolios concentrated in a few key stocks, global portfolios concentrated in U.S. stocks and asset allocation portfolios concentrated in equities.

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Measuring diversification

An important method for understanding the historical context of these recent conditions is measuring the concentration of asset class performance (i.e., how unusual are the levels of narrow performance?). One tool that can help us measure the breadth of market performance is a **diffusion index**. Here's how it works:

$$\frac{\text{Securities ahead of the index} - \text{Securities behind the index}}{\text{Securities ahead of the index} + \text{Securities behind the index}}$$

This measurement can be used to examine both individual stocks and broad assets in a portfolio. When the result is high, it means that more than half of the securities or assets are doing better than the index. And when it's low, it means that less than half are doing better than the index.

Using this tool, we looked at the historical level of concentrated performance among 12 different asset classes that frequently comprise a multi-asset approach: U.S. equity, international developed equity, emerging market equity, U.S. Treasuries, international developed Treasuries, emerging market bonds, U.S. investment grade, U.S. mortgage-backed securities, U.S. high yield, global inflation linked bonds, REITs and commodities.

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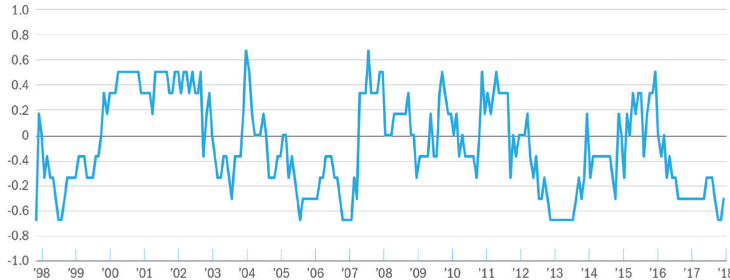
Measuring asset class diffusion reveals today's narrow market



Source: Columbia Threadneedle Investments as of October 8, 2018, based on rolling nine-month data for the MSCI USA Index, MSCI EAFE Index, MSCI EM Index, Bloomberg Barclays U.S. Treasury Index, FTSE WGBI x-US Index, JPM EMBI Global Index, Bloomberg Barclays U.S. Corporate Bond Index, Bloomberg Barclays High Yield Index, Bloomberg Barclays US Mortgage-backed Securities Index, Bloomberg Barclays Global TIPS Index, FTSE NAREIT Equity REIT Index, Bloomberg Commodity Index, calculated on a monthly basis. See index definitions below.

Our analysis revealed that the market was very narrow for most of this year. In this environment, a diversified approach suffers and any kind of risk allocation strategy — which favors lower volatility assets, like bonds, compared to higher volatility assets, like equity — also underperforms.

Why diversification still benefits investors

The obvious question is where do we go from here? Of all the arguments for diversification, the one we believe is most important in this environment is **drawdown protection.** We are proponents of diversification to help provide downside protection in a portfolio, but consider a diversification approach based on the allocation of risk, not capital.

Risk allocation assigns portfolio weights based on historic asset risk levels and may have a leveraged bond component. And it could improve the drawdown benefit of a globally balanced portfolio. As shown below, bonds and other asset classes mitigated drawdown in the early 2000s. The benefit of this diversified risk allocation approach wasn't as apparent during the 2008 global financial crisis, but there was a faster recovery from the depths of the drawdown—and this benefited a risk-balance investor in the long term. More recently equity has done so well that a simple global balanced approach has outperformed anything with leveraged bonds (like risk allocation).

Risk allocation lessens portfolio drawdowns (return %)

Global Balanced (60% MSCI ACWI/40% Bloomberg Barclays Global Agg) | Modeled Risk Allocation Portfolio

Source: Columbia Threadneedle Investments as of October 8, 2018. The risk allocation portfolio was constructed using the following indices and weights: 35% MSCI ACWI Index, 25% Bloomberg Barclays US Treasury Index, 25% WGBI ex-US Index, 8% JPM EMBI Global Index, 8% Bloomberg Barclays US Corporate Index, 15% Bloomberg Barclays US High Yield Index, 5% Barclays US Mortgage Backed Securities Index, 15% Bloomberg Barclays Global TIPS Index, 7% FTSE NAREIT Equity REIT Index, 7% Bloomberg Commodities Index, -50% US 3m Libor. Data for these hypothetical portfolios was calculated by retroactively applying monthly rebalancing and reinvestment of income and capital gains to historical index data with the benefit of hindsight. It does not represent the actual investment decisions of the advisor or the the effect material economic, market factors or other factors may have had on decision-making during the period if the adviser had actually been managing client assets.

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Bottom line

Most of 2018 rewarded investors with concentrated bets in equities, and we'll likely see these periods again. But unless someone can perfectly time the ebbs and flows of the market, the risk of significantly greater drawdowns increases by staying concentrated.

Diversification does not assure a profit or protect against a loss. **Past performance does not guarantee future results.** It is not possible to invest in an index. The **Bloomberg Barclays US Treasury Index** includes public obligations of the U.S. Treasury. The **Bloomberg Barclays High Yield Index** covers the universe of fixed rate, non-investment grade debt. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as Emerging Markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, and 144-As are also included. The **Bloomberg Barclays U.S. Corporate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. The **Bloomberg Barclays Global Aggregate Index** is an unmanaged broad-based, market-capitalization-weighted index that is designed to measure the broad global markets for U.S. and non-U.S. corporate, government, governmental agency, supranational, mortgage-backed and asset-backed fixed-income securities. **Bloomberg Barclays Global TIPS Index** consists of inflation-protection securities issued by the US Treasury. They must have at least one year until final maturity and at least $250 million par amount outstanding. The **Bloomberg Commodity Index** is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The **Bloomberg Barclays Mortgage-backed Securities Index** is a market value-weighted index which covers the mortgage-backed securities component of the Bloomberg Barclays U.S. Aggregate Bond Index is composed of agency mortgage-backed passthrough securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year. The index includes reinvestment of income. The **FTSE/NAREIT Index** is an index that reflects performance of all publicly-traded equity REITs. The **FTSE World Government Bond Index** (WGBI) is an index of bonds issued by governments in the U.S., Europe and Asia. The **JPMorgan EMBI Global Index** tracks returns for actively traded external debt instruments in emerging market The **MSCI All Country World Index** is a free float-adjusted market capitalization index that is designed to measure equity market. performance in the global Developed and Emerging Markets. The **MSCI USA Index** is designed to measure the performance of the large and mid cap segments of the US market. The **MSCI EAFE Index** captures large and mid cap representation across 21 Developed Markets countries* around the world, excluding the US and Canada. The **MSCI EM Index** captures large and mid cap representation across 24 Emerging Markets (EM) countries. The **S&P 500 Index** is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value.

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