DIVERSIFICATION STRIKES BACK

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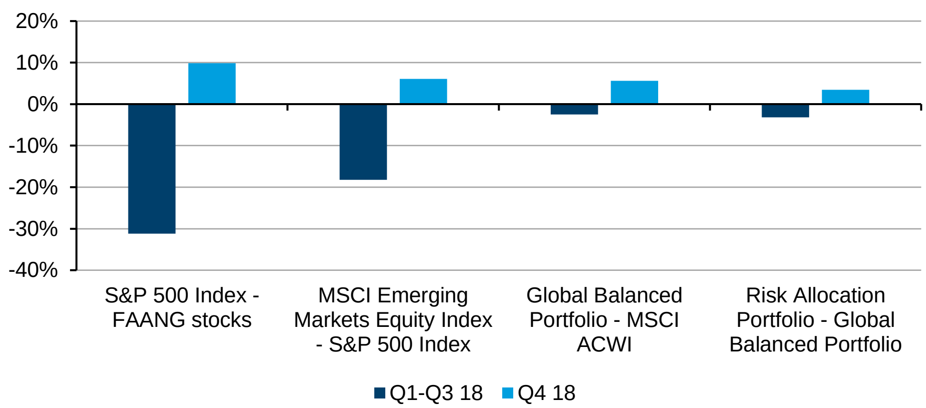
What a difference a quarter can make. When I sat down to write about markets at the end of the third quarter, the common theme both within and across them was the “disappointment of diversification.” A few key U.S. stocks were doing better than a widely limping market, and U.S. stocks were handily outperforming both non-U.S. developed and emerging markets. Fixed income allocations provided no ballast for global balanced investors, and risk allocation portfolios were doing worse still. In the fourth quarter of 2018, each of these observations reversed. The resumption of variation in return among asset classes (even in a generally negative environment) is an important and encouraging observation for multi-asset investors.

Exhibit 1: Performance trends reversed dramatically in the fourth quarter of 2018

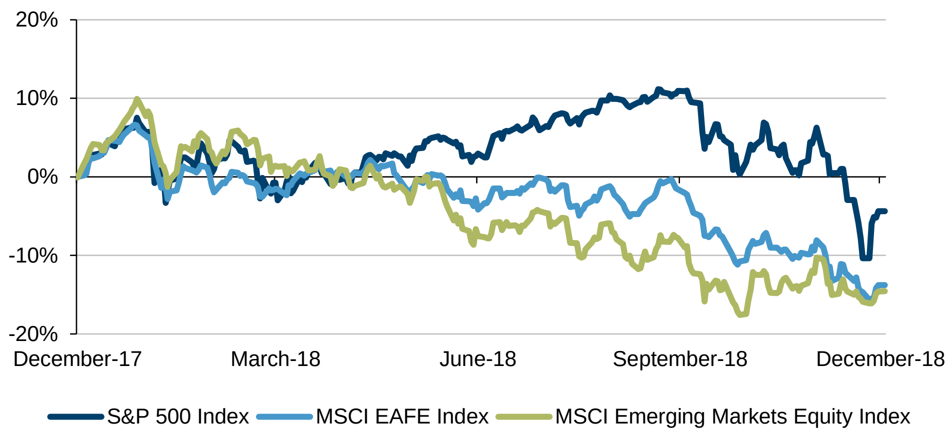


Source: Columbia Threadneedle Investments. Chart displays relative cumulative performance for periods shown. FAANG stocks represent the equal weighted returns of Facebook, Apple, Amazon, Netflix and Alphabet’s Google. Global Balanced Portfolio represents the returns of 60% MSCI ACWI and 40% Bloomberg Barclays Global Aggregate Bond Index. Risk Allocation Portfolio represents the returns of 25% MSCI ACWI / 75% Barcap Global Aggregate leveraged 1.5X (which reflects an equally weighted equity and bond risk allocation). Please see endnotes for index definitions.

Mean reversion in several trends that we saw earlier in 2018 played a big role in the recovery of diversification. As shown in Exhibit 1, the S&P 500 Index underperformed the headline FAANG stocks (Facebook, Apple, Amazon, Netflix and Alphabet's Google) by 31% in the first three quarters of 2018, while the S&P 500 outperformed those stocks by 10% in the fourth quarter. Netflix led the pack for most of the year with a 95% total return, but it gave back 30% in the fourth quarter. Facebook was the sole underperformer among these stocks in the first three quarters of 2018—down 7% after a series of concerning stories on a lax attitude toward user data—and the stock continued to go down in the fourth quarter. As I write, volatility in Apple continues, with the stock down 10% on one day (1/3/19) after weaker demand from China weighed on earnings.

The underperformance of emerging markets was perhaps the biggest asset allocation story of the first three quarters of 2018, with the MSCI World Index up 5% and the MSCI Emerging Markets Index down 8%, for a spread of 13% in favor of developed markets. Here, too, we saw a reversal in the trend: in the fourth quarter, the MSCI World Index was down 13%, and the MSCI Emerging Markets Index was down less than that (- 8%), for a spread of 5% in favor of emerging markets (Exhibit 2).

Exhibit 2: Emerging-market underperformance narrowed in the last quarter of 2018



Source: Columbia Threadneedle Investments. Please see endnotes for index definitions.

Beyond the reversal, there are two interesting things about these dynamics:

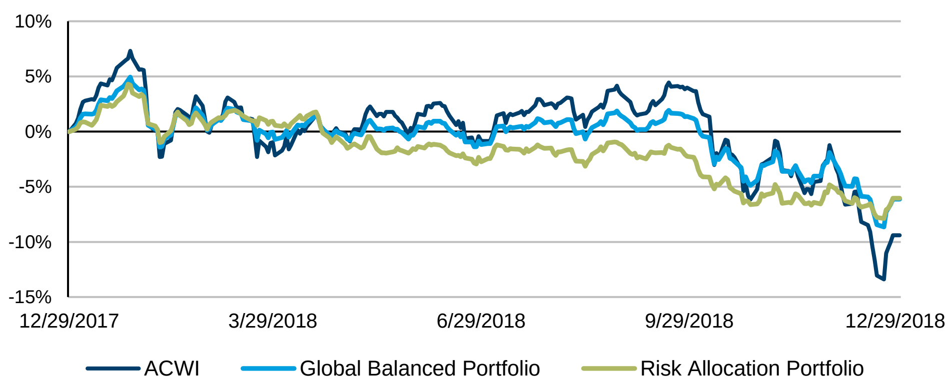
It is very rare for emerging markets to beat developed or U.S. equity markets in quarters where equities struggle, since emerging-market stocks typically have much higher beta. In fact, in the 30-plus-year history of the MSCI Emerging Markets Index, outperformance has only happened in three other quarters when the U.S. was down by more than 5%: twice during the early 2000s in the wake of the tech plunge and subsequent recession, and once during the Global Financial Crisis.

We were also struck by the outperformance of emerging markets relative to MSCI EAFE stocks in the fourth quarter. While the MSCI EAFE outperformed the S&P 500 for the period by about 1%, the magnitude of outperformance significantly trailed the emerging markets–U.S. differential. Here, mean reversion was not the driver of the return differential. Brexit uncertainty continues to weigh on these markets, so it is not surprising that Europe and the U.K. would continue to see volatility and adverse market moves, in our view.

Within fixed income, we saw a significant shift in Federal Reserve (Fed) rate-hike expectations over 2018, which also helped to drive the recovery of a diversified approach. At the beginning of 2018, investors were not discussing *if* the Fed would hike, but *how many* hikes would occur over the year and in 2019. There was so much upward pressure on rates that bonds did not provide the needed diversification to multi-asset portfolios—for example, during the February volatility spike. In the fourth quarter, while many expected yields to rise, they instead fell on policy uncertainty. The U.S. 10-year Treasury bond yield fell from a level of 3.06% on September 30 to 2.68% at year-end. In the fourth quarter, the Barclays Global Aggregate Index had a -0.11 correlation with the MSCI ACWI. This correlation was +0.11 for the first nine months of the year.

Heading into 2019, we see much greater uncertainty on the subject of future Fed hikes; there is even talk of pressure to *lower* rates if equity volatility continues. This uncertainty has improved the return prospects for fixed income and raises the prospect of these assets continuing to provide much-needed diversification.

Exhibit 3: After a recovery in the fourth quarter, diversified investors saw shallower drawdowns in 2018



Source: Columbia Threadneedle Investments. Global Balanced Portfolio represents the returns of 60% MSCI ACWI and 40% Bloomberg Barclays Global Aggregate Bond Index. Risk Allocation Portfolio represents the returns of 25% MSCI ACWI / 75% Bloomberg Barclays Global Aggregate Bond Index leveraged 1.5X (which reflects an equally weighted equity and bond risk allocation). Please see endnotes for index definitions.

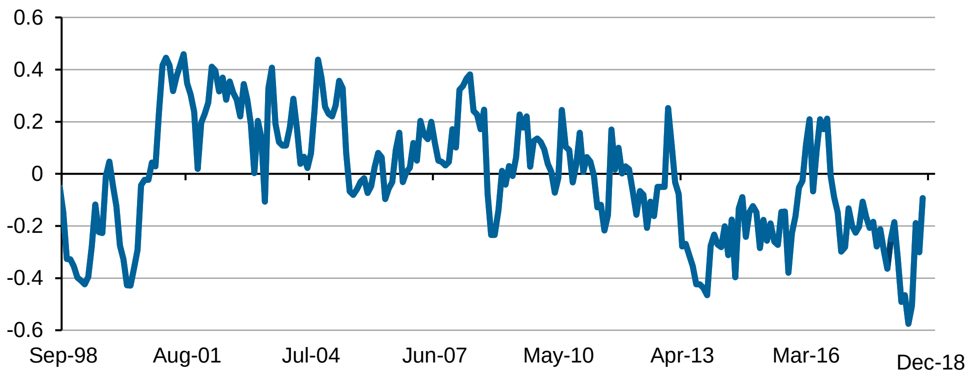
After a year like 2018—when for much of the year, it seemed like a more diversified portfolio translated to worse results—we were happy to see diversification providing a benefit to investors in the fourth quarter and risk allocation providing even greater benefit. The aggregate of the asset class trends observed above are evident in comparisons of the MSCI ACWI, a global balanced portfolio comprised of 60% MSCI ACWI and 40% Bloomberg Barclays Global Aggregate Bond Index, and a diversified risk allocation approach comprised of 25% MSCI ACWI / 75% Bloomberg Barclays Global Aggregate leveraged to 1.5X.

A global balanced approach underperformed the MSCI ACWI Index by 3% going into the end of the third quarter, and it roared back with a 6% return in the fourth quarter to come out ahead for the year. Risk allocation trailed 3% versus Global Balanced, and 6% to ACWI, over the first three quarters. It rebounded with a 3% return versus Global Balanced, and 9% versus ACWI, over the course of the fourth quarter.

WHAT IS THE TREND?

Last quarter, we introduced the Diversification Diffusion Indicator, which assigned a score between -1 and 1 and looked at diversification in four areas: stocks, sectors, countries, and assets. We looked at this calculation on a rolling three-quarter basis, based on our observations three quarters of the way through the year. We updated the same numbers, and that score shot up from -0.5 as of September 30 to -0.1 as of December 31 (Exhibit 4).

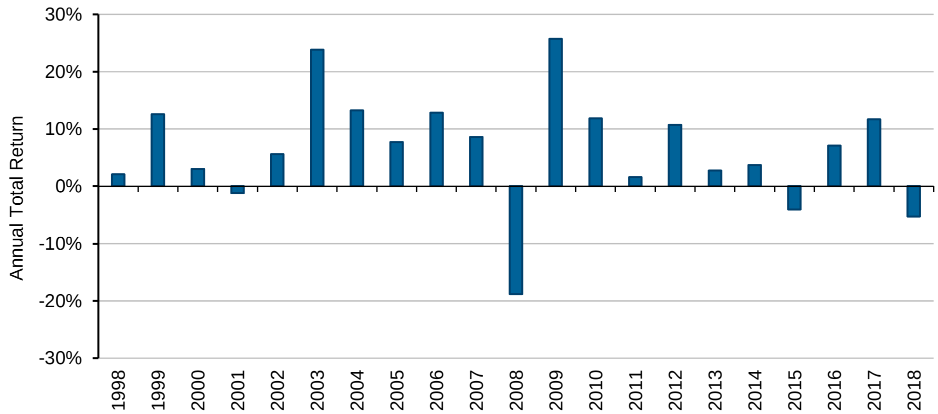
Exhibit 4: Our Diversification Diffusion Indicator saw dramatic improvement in the fourth quarter of 2018



Source: Columbia Threadneedle Investments. Based on rolling 1-year MSCI USA Index, MSCI EAFE Index, MSCI EM Index, Bloomberg Barclays US Treasury Index, FTSE WGBI x-US Index, JPM EMBI Global Index, Barclays US Corporate Index, Barclays US High Yield Index, Bloomberg Barclays US Mortgage-backed Securities Index, Bloomberg Barclays Global TIPS Index, FTSE NAREIT Equity REIT Index and Bloomberg Commodity Index, calculated on a monthly basis. A simple average was applied to stock, sector, country and asset data employing the following calculation: (Securities ahead of the Index - Securities behind the Index) / (Securities ahead of the Index + Securities behind the Index). When the measure is high, more than half of the securities or assets are doing better than the Index, and when the measure is low, less than half are doing better than the Index. Please see endnotes for index definitions.

Considering the 2018 performance of asset classes in a historical context, we can see that 2018 was the worst year since 2008 for an equally weighted diversified portfolio, and it was only one of four years in which this portfolio was negative (Exhibit 5).

Exhibit 5: It is rare to see such poor performance from a diversified portfolio



Source: Columbia Threadneedle Investments. Chart represents annual returns of an equally weighted portfolio comprised of the following asset class (with their proxy): US Equity (S&P 500 Index); Non US Developed Equity (MSCI EAFE); Emerging Markets (MSCI Emerging Markets Equity Index); US Treasuries (Bloomberg Barclays US Treasury Total Return Unhedged USD Index); Global Bonds (FTSE World Government Bond Index); Emerging Market Bonds (J.P. Morgan Emerging Market Bond Index Global Index); Investment Grade Bonds (Bloomberg Barclays US Corporate Total Return Index); High Yield (Bloomberg Barclays US Corporate High Yield Total Return Index); Mortgage-backed Securities (Bloomberg Barclays US MBS Index); TIPS (Bloomberg Barclays Global Inflation-Linked Total Return Index); REITs (FTSE NAREIT All Equity REITs Index); Commodities (Bloomberg Commodity Index). Please see endnotes for index definitions.

We strongly believe that diversified investors will be rewarded in 2019, as they have been after prior years of poor performance (e.g., 2002, 2009 and 2016). However, it is important to note that just as 2018 was not as bad as 2008, we cannot expect 2019 to be strong as 2009, the strongest year on record for the historical period for which we have full data.

Volatility remains elevated, and a number of the factors that drove market uncertainty in late 2018 are still at play, including trade discussions, Brexit and U.S. government financial-policy tensions. If some recent disappointing earnings calls are portents of the future, then we could continue to see earnings announcements weigh on 2019 equity performance. However, we believe that certain asset classes (such as specific rates and energy trades) and geographies (such as Japan and possibly emerging markets) are interesting areas for recovery, which is why we believe investors should diversify their holdings across as many stocks, sectors, countries and assets as possible.

Endnotes:

The Bloomberg Barclays U.S. 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-emerging-market-grade countries are included. Original issue zeros, 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 Inflation-Linked Index includes securities which offer the potential for protection against inflation, as their cash flows are linked to an underlying inflation index.

The Bloomberg Barclays Global TIPS Index consists of inflation-protection securities issued by the U.S. Treasury. They must have at least 1 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

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 3-Month Treasury Bill Index is an unmanaged index that tracks short-term U.S. government debt instruments.

The FTSE World Government Bond Index (WGBI) is an index of bonds issued by governments in the U.S., Europe and Asia.

The J.P. Morgan EMBI Global Index tracks returns for actively traded external debt instruments in emerging markets.

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 U.S. market.

The MSCI EAFE Index captures large- and mid-cap representation across 21 developed-market countries around the world, excluding the U.S. and Canada.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries.

The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value.

Diversification does not assure a profit or protect against loss.

Past performance does not guarantee future results. It is not possible to invest in an index. Important note: Charts are for illustrative purposes only and is not intended to represent any investment product.

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