Diversification: It’s All About (Asset) Class
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If one were to poll investors and investment professionals to determine their ideal investment scenario, the vast majority would no doubt agree it is a double-digit total return in all economic environments, each and every year. Naturally, they would also agree that the worst-case scenario is an overall decrease in asset value. But despite this knowledge, very few achieve the ideal and many encounter the worst-case scenario. (For more information, read Five Things To Know About Asset Allocation.)

The reasons for this are diverse: misallocation of assets, pseudo-diversification, hidden correlation, weighting imbalance, false returns and underlying devaluation. The solution, however, could be simpler than you’d expect. In this article we’ll show how to achieve true diversification through asset class selection, rather than stock picking and market timing. (For background reading on asset allocation, check out Asset Allocation Strategies.)

The Importance of Asset Class Allocation

Most investors, including investment professionals and industry leaders, do not beat the index of the asset class in which they invest, according to two studies by Brinson, Beebower et al entitled “Determinants of Portfolio Performance” (1986) and “Determinants of Portfolio Performance II: An Update” (1991). This conclusion is also backed up in a third study by Ibbotson and Kaplan entitled “Does Asset Allocation Policy Explain 40%, 90% or 100% of Performance?” (2000). Which begs the question, if a U.S. equities growth fund does not consistently equal or beat the Russell 3000 Growth Index, what value has the investment management added to justify their fees? Perhaps simply buying the index would be more beneficial. (To learn more about active management that gives passive returns, check out Beware The Index Hugger.)
Furthermore, the studies show a high correlation between the returns investors achieve and the underlying asset class performance; for example, a U.S. bond fund or portfolio will generally perform much like the Lehman Aggregate Bond Index, increasing and decreasing in tandem.

This shows that, as returns can be expected to mimic their asset class, asset class selection is far more important than both market timing and individual asset selection. Brinson and Beebower concluded that market timing and individual asset selection accounted for only 6% of the variation in returns, with strategy or asset class making up the balance.

**Broad Diversification Across Multiple Asset Classes**

Many investors do not truly understand effective diversification, often believing they are fully diversified after spreading their investment across large caps, mid or small caps, energy, financial, healthcare or technology stocks, or even investing in emerging markets. In reality, however, they have merely invested in multiple sectors of the equities asset class and are prone to rise and fall with that market.

If we were to look at the Morningstar style indexes or their sector indexes, we would see that despite slightly varying returns, they generally track together. However, when one compares the indexes as a group or individually to the commodities indexes, we do not tend to see this simultaneous directional movement. Therefore, only when positions are held across multiple uncorrelated asset classes is a portfolio genuinely diversified and better able to handle market volatility as the high-performing asset classes can balance out the underperforming classes.

**Hidden Correlation**

An effectively diversified investor remains alert and watchful, because correlation between classes can change over time. International markets have long been the staple for diversification; however, there has been a marked increase in correlation between the global equity markets. This is most easily seen among the European markets after the formation of the European Union. In addition, emerging markets are also becoming more closely correlated with U.S. and U.K. markets. Perhaps even more troubling is the increase in what was originally unseen correlation between the fixed income and equities markets, traditionally the mainstay of asset class diversification.

It is possible that the increasing relationship between investment banking and structured financing may be the cause for this, but on a broader level, the growth of the hedge fund industry could also be a direct cause of the increased correlation between fixed income and equities as well as other smaller asset classes.

For example, when a large, global multi-strategy hedge fund incurs losses in one asset class, margin calls may force it to sell assets across the board, universally affecting all the other classes in which it had invested. (For related reading, check out *Hedge Fund Failures Illuminate Leverage Pitfalls* and *Are Structured Retail Products Too Good To Be True?*)
Class Realignment

Ideal asset allocation is not static. As the various markets develop, their varying performance leads to an asset class imbalance, so monitoring and realignment is imperative. Investors may find it easier to divest underperforming assets, moving the investment to asset classes generating better returns, but they should keep an eye out for the risks of overweighting in any one asset class, which can often be compounded by the effects of style drift. (To learn more about drift, see *Don’t Panic If Your Mutual Fund Is Drifting.*)

An extended bull market can lead to overweighting in an asset class that may be due for a correction. Investors should realign their asset allocation at both ends of the performance scale.

Relative Value

Asset returns can be misleading, even to a seasoned investor. They're best interpreted relative to the performance of the asset class, the risks associated with that class and the underlying currency. One cannot expect to receive similar returns from tech stocks and government bonds, but one should identify how each fits into the total investment holding. Effective diversification will include assets classes of varying risk profiles held in various currencies. A small gain in a market with a currency that increases relative to your portfolio currency can outperform a large gain in a retreating currency — and, likewise, large gains can become losses when converted back to a strengthened currency. For evaluative purposes, the investor should analyze the various asset classes in relation to their “home currency” and a neutral indicator. (For a detailed breakdown of this effect, check out *The Impact Of Currency Conversions.*)

The Swiss franc, which has been one of the more stable currencies since the 1940s with relatively low inflation, can be one benchmark against which to measure other currencies. For 2007, the S&P 500 was up roughly 3.53%. However, when factoring in the American dollar's devaluation against most currencies in the same year, investors would effectively experience a net loss. In other words, an investor who chose to sell his or her entire portfolio at the end of 2007 would get more U.S. dollars than one year previously — but the investor could buy less with those dollars than the year before relative to other foreign currencies. When the home currency devalues, investors often ignore the steady decrease of their investments’ buying power, which is similar to holding an investment that yields less than inflation.

Conclusion

All too often, private investors become bogged down with stock picking and trading — activities that are not only time-consuming, but can be overwhelming. It could be more beneficial — and significantly less resource-intensive — to take a broader view and concentrate on the asset classes. With this macro view, the investor’s individual investment decisions are simplified, and they may even be more profitable.