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Diversification: The Boring Winner

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Snapshot

- Year in and year out, a single asset class will often outperform a well-diversified portfolio.
- Yet outperformance of any single asset class is notoriously difficult to predict—and a diversified portfolio will tend to outperform over the long run, especially in risk-adjusted terms.
- Although the middle-of-the-road performance tendencies of diversified strategies can lead to challenging conversations with some clients, diversifying is still the right thing to do.

In a world where the best- and worst-performing asset classes tend to dominate the headlines, it's easy to lose sight of the fact that a diversified investment portfolio is generally the most reliable approach for meeting long-term investment objectives. Diversification is a time-tested component of portfolio construction, especially through the lens of risk-adjusted returns in terms of Sharpe ratios. Historically, the result is a less volatile portfolio that tends to produce something close to middle-of-the-road performance year in and year out. This is in contrast to the best- and worst-performing asset classes, which often generate significant media attention despite volatility in returns and market leadership—hence the sentiment that diversification is rather boring.

Diversification rarely wins in any given year ...

By design, diversified portfolios hold a mix of asset classes, some of which outperform and some of which underperform in a given year. As a result, diversified portfolios will never beat the top-performing asset class in any given year. However, it's notoriously difficult for investors to consistently pick top-performing asset classes. Nevertheless, to some investors, more-stable diversified strategies lack the appeal of flavour-of-the-month champions like the high-flying technology stocks or rapidly rising emerging markets. This point of view arises from some well-known cognitive and emotional biases, which we have covered at length in our series of Behavioural Finance papers.

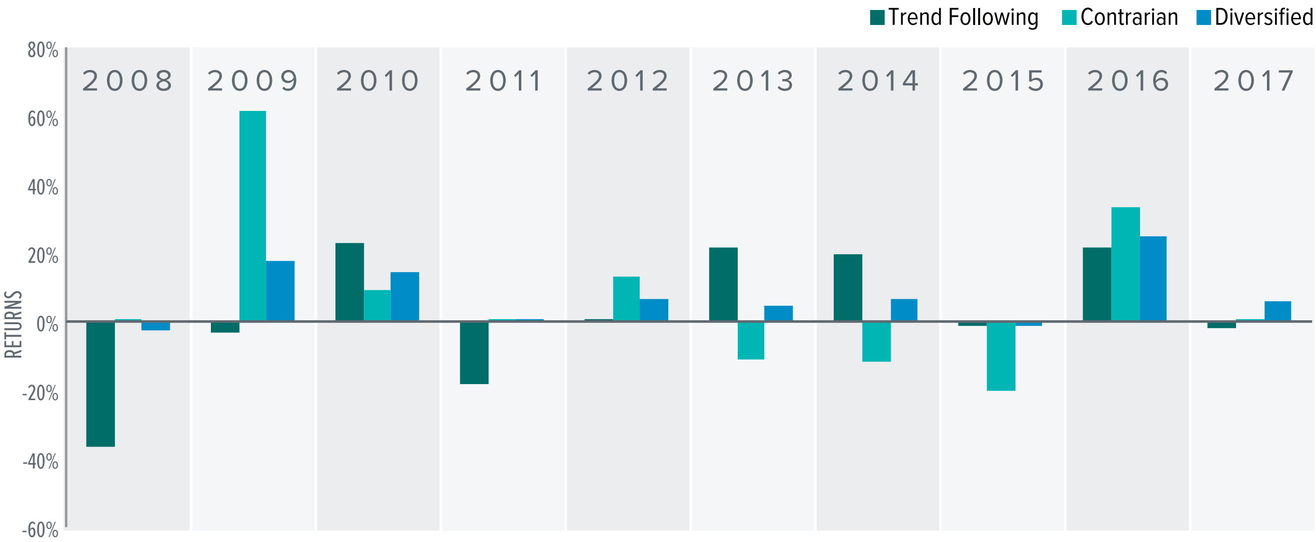
To counter these biases, we developed a framework based on our analysis of three highly simplified investment strategy types (described below)—which has demonstrated the power of diversification.

Trend-Following Strategy: Invests in the top-performing asset class of the prior year

Contrarian Strategy: Invests in the worst-performing asset class of the prior year

Diversified Strategy: Invests equally in all available asset classes (listed on page 3)

We found that over the last 10 years, the trend-following strategy and the contrarian strategy each were the top performer 40% of the time. Meanwhile, the diversified strategy came out on top in only two of those 10 years.

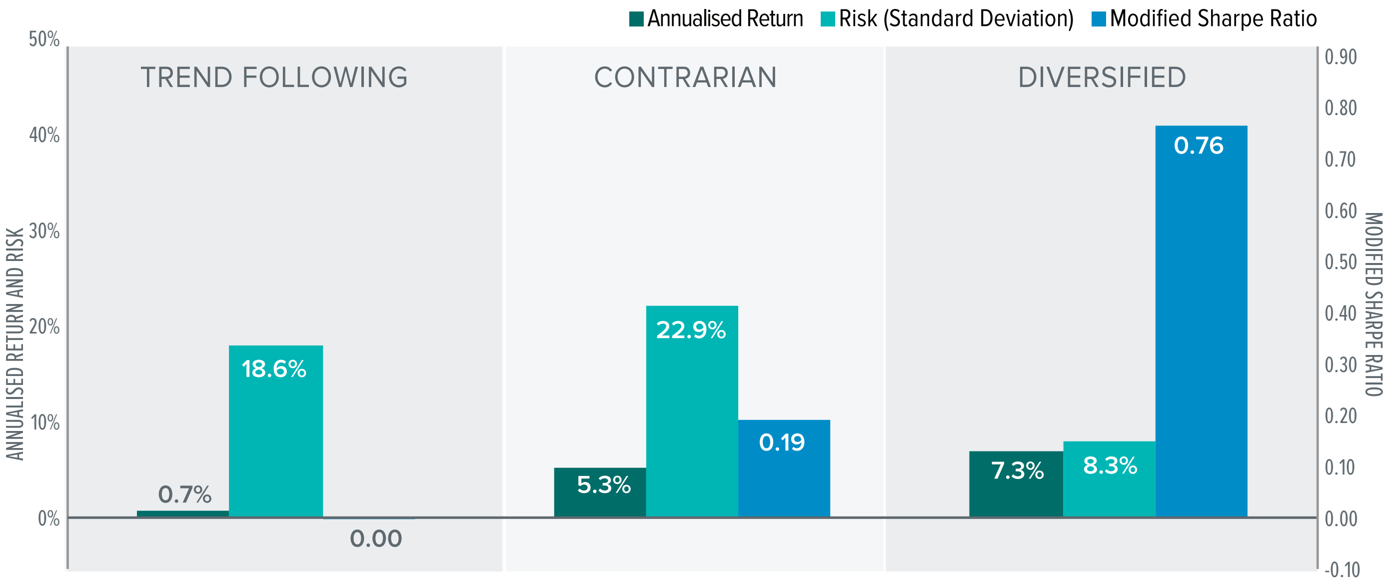


SOURCES: SEI based on data from Bloomberg
Past performance is not a reliable indicator of future results. Performance stated in GBP.

... But diversification also rarely loses, and wins over time

We've already established that a diversified strategy can't beat the top-performing asset class in a given year; but, by definition, it can't be the worst performer either.

In terms of risk-adjusted returns, despite rarely beating the two other strategies in a single year, the diversified approach has won, hands down, over the past decade. While the contrarian strategy produced solid returns overall, it still significantly trailed the diversified strategy and with much higher volatility. The trend-following strategy also had relatively high volatility and barely produced a positive return over the 10 year period. The diversified approach provided a respectable overall return with far less volatility and, as a result, much higher risk-adjusted returns.



SOURCES: SEI based on data from Bloomberg; 10 years as at 31/12/17
Past performance is not a reliable indicator of future results. Performance stated in GBP.

It's not always easy to do the right thing

This tells us that trend-following and contrarian strategies are double-edged swords; while they may offer a better chance of outperforming many asset classes and diversified portfolios, they also impose a higher probability of significantly underperforming. Meanwhile, the relative stability conferred by a diversified strategy may help to avoid significant losses while reducing the overall volatility of the investment experience. And portfolios that can avoid extreme losses while enjoying lower volatility tend to outperform in the long run. This is why we continue to preach diversification: it may seem boring, but the past 10 years of performance illustrate that diversified strategies have offered benefits that the other approaches have failed to provide.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Global Fixed 42.5%	Emerging Equity 61.1%	Emerging Equity 23.1%	UK Linkers 23.3%	Developed ex-UK 13.4%	US Equity 31.0%	UK Linkers 21.4%	Developed ex-UK 7.4%	US High Yield 39.8%	Emerging Equity 25.3%
Emerging Debt 26.5%	US High Yield 42.8%	US Equity 21.1%	UK Fixed 13.5%	Emerging Equity 12.9%	Developed ex-UK 21.9%	US Equity 19.7%	US Equity 6.2%	US Equity 34.5%	Developed ex-UK 15.3%
Cash 5.4%	UK Equity 30.2%	Commodities 21.0%	Global Fixed 6.2%	UK Equity 12.3%	UK Equity 20.8%	UK Fixed 13.9%	Global Fixed 2.4%	Commodities 33.4%	UK Equity 13.1%
UK Fixed 4.3%	Developed ex-UK 17.3%	US High Yield 19.2%	US High Yield 5.5%	Emerging Debt 12.1%	US High Yield 5.3%	US High Yield 8.9%	US High Yield 1.0%	Emerging Equity 32.7%	US Equity 10.6%
UK Linkers 3.3%	US Equity 15.8%	Emerging Debt 17.6%	Emerging Debt 3.6%	US Equity 11.2%	UK Linkers 0.6%	Emerging Debt 7.0%	UK Equity 0.9%	Emerging Debt 31.4%	Emerging Debt 3.0%
US High Yield 0.5%	Emerging Debt 12.2%	UK Equity 14.6%	US Equity 1.6%	US High Yield 10.6%	Cash 0.3%	Global Fixed 6.9%	UK Fixed 0.5%	UK Linkers 27.4%	UK Fixed 2.6%
Commodities -12.5%	Commodities 7.3%	Developed ex-UK 12.1%	Cash 0.5%	UK Fixed 6.1%	UK Fixed -2.6%	Emerging Equity 4.0%	Cash 0.4%	Global Fixed 21.8%	UK Linkers 2.5%
US Equity -14.7%	UK Linkers 5.6%	Global Fixed 9.3%	UK Equity -3.4%	Cash 0.5%	Global Fixed -4.5%	Developed ex-UK 2.1%	UK Linkers -1.2%	Developed ex-UK 21.6%	Cash 0.2%
Developed ex-UK -20.3%	UK Fixed 3.7%	UK Linkers 9.0%	Commodities -12.9%	UK Linkers 0.5%	Emerging Equity -4.5%	UK Equity 1.2%	Emerging Debt -1.8%	UK Equity 16.8%	US High Yield -1.9%
UK Equity -29.9%	Cash 0.8%	UK Fixed 7.9%	Developed ex-UK -13.6%	Global Fixed -0.4%	Emerging Debt -8.8%	Cash 0.4%	Emerging Equity -10.0%	UK Fixed 10.6%	Global Fixed -2.0%
Emerging Equity -36.5%	Global Fixed -3.5%	Cash 0.4%	Emerging Equity -18.0%	Commodities -5.5%	Commodities -11.3%	Commodities -11.8%	Commodities -20.3%	Cash 0.3%	Commodities -7.2%

Sources: SEI based on data from Bloomberg
Annual returns in GBP through 31 December 2017. Past performance is not a reliable indicator of future results.

Chart disclosures

Asset-class returns are based on the same indexes as indicated below. Performance begins 1/1/2008 and continues through 31/12/2017. In each of these years, "Trend Following" uses the current-year return of the best-performing asset class of the previous year. "Contrarian" uses the current year return of the worst-performing asset class of the previous year. "Diversified" uses a return equal to the return of a portfolio of equally weighted asset-class returns in each year.

Asset Class Indices

UK Equity = FTSE All Share Index, US Equity = FTSE/Russell 3000 Index, Developed ex-UK = MSCI EAFE ex-UK, Emerging Equity = MSCI Emerging Markets Index, Global Fixed = Bloomberg Barclays Global Aggregate Index, UK Fixed = ICE BofA ML Sterling Broad Market Index, UK Linkers = FTSE Actuaries UK Index-Linked Gilts Over 5 Years Index, US High Yield = ICE BofA Merrill Lynch US High Yield Constrained Index, Emerging Debt = 50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI EM Global Diversified, Commodities = Bloomberg Commodity Total Return Index, Cash = ICE BofA Merrill Lynch British Pound 1-Month Deposit Bid Rate Average Index.

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