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.

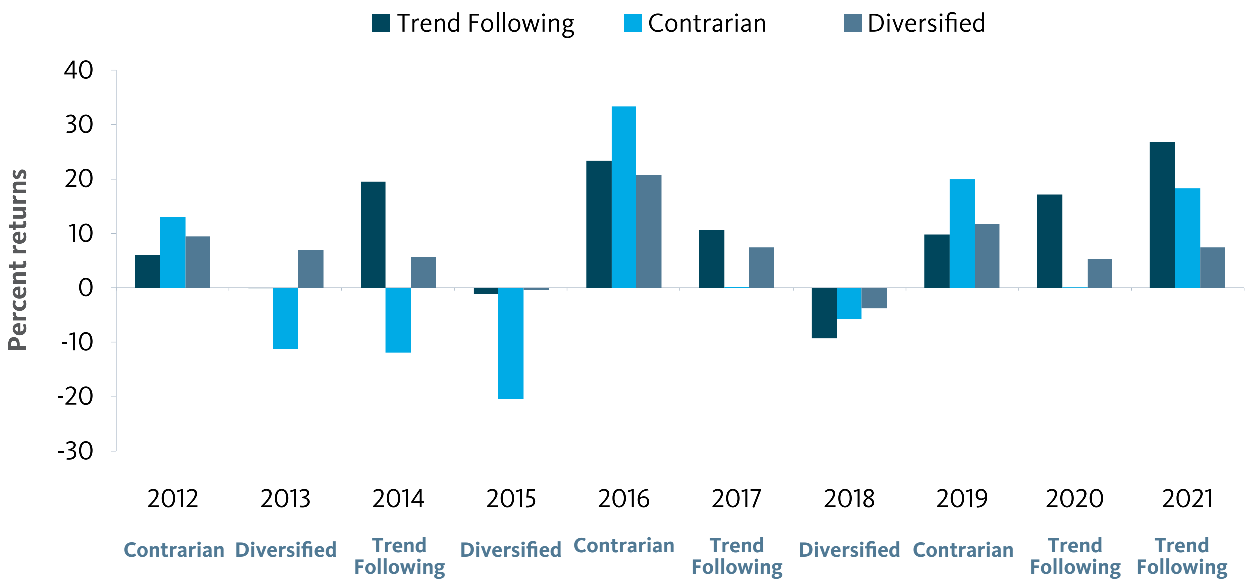
To counter these biases, we developed a framework based on our analysis of three highly simplified investment strategy types (described below)—which has demonstrated the power of diversification.

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 was the top performer 40% of the time. Meanwhile, the contrarian and diversified strategies each came out on top in three of those 10 years.

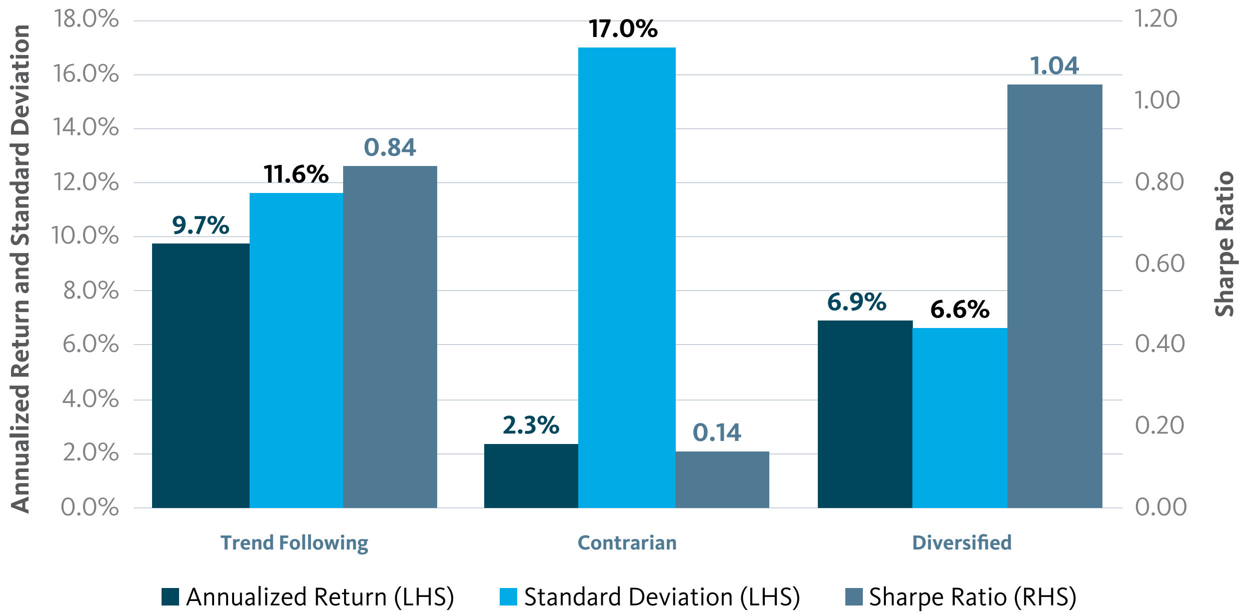


Sources: SEI based on data from Bloomberg
Past performance is not a reliable indicator of future results. Performance stated in GBP.

... 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. The contrarian strategy produced moderate returns overall, and with much higher volatility. The trend-following strategy also had relatively high volatility , but produced a strong 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 31/12/2021
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

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
UK Linkers 23.3%	US Equity 31.1%	UK Linkers 21.3%	Japan Equity 18.2%	US Equity 34.5%	Emerging Equity 25.4%	Emerging Debt 0.7%	US Equity 26.0%	US Equity 17.2%	Commodities 28.3%
Europe ex-UK 16.0%	Europe ex-UK 25.3%	US Equity 19.6%	US Equity 6.3%	Commodities 33.4%	Europe ex-UK 15.8%	US Equity 0.6%	Europe ex-UK 20.0%	Emerging Equity 14.7%	US Equity 26.8%
US High Yield 15.5%	Japan Equity 24.7%	UK Fixed 13.9%	Europe ex-UK 5.1%	Emerging Equity 32.6%	Japan Equity 15.6%	Cash 0.5%	UK Equity 19.2%	UK Linkers 12.4%	UK Equity 18.3%
Emerging Equity 13.0%	UK Equity 20.8%	Global Fixed 7.9%	Global Fixed 1.4%	Emerging Debt 31.3%	UK Equity 13.1%	Global Fixed 0.1%	Japan Equity 14.6%	Japan Equity 9.5%	Europe ex-UK 16.7%
UK Equity 12.3%	US High Yield 7.6%	Emerging Debt 7.1%	UK Equity 1.0%	UK Linkers 27.3%	US Equity 10.6%	UK Fixed -0.1%	Emerging Equity 13.8%	UK Fixed 8.3%	US High Yield 5.1%
Emerging Debt 12.0%	Cash 0.3%	Emerging Equity 3.9%	UK Fixed 0.5%	Japan Equity 23.4%	US High Yield 6.2%	UK Linkers -0.4%	US High Yield 12.2%	Europe ex-UK 7.5%	UK Linkers 4.1%
US Equity 11.3%	Global Fixed 0.0%	US High Yield 2.7%	Cash 0.4%	Europe ex-UK 18.6%	Emerging Debt 3.0%	US High Yield -3.9%	Emerging Debt 9.8%	Global Fixed 5.0%	Japan Equity 2.0%
UK Fixed 6.1%	UK Linkers -0.1%	Japan Equity 2.7%	UK Linkers -1.1%	US High Yield 16.9%	UK Fixed 2.6%	Commodities -5.8%	UK Fixed 8.0%	US High Yield 4.6%	Cash -0.1%
Global Fixed 5.9%	UK Fixed -2.6%	UK Equity 1.2%	Emerging Debt -1.5%	UK Equity 16.8%	UK Linkers 2.5%	Japan Equity -8.4%	UK Linkers 6.9%	Emerging Debt 0.8%	Global Fixed -1.5%
Japan Equity 2.8%	Emerging Equity -4.4%	Cash 0.4%	US High Yield -4.7%	UK Fixed 10.6%	Global Fixed 1.9%	Emerging Equity -9.3%	Global Fixed 6.5%	Cash 0.1%	Emerging Equity -1.6%
Cash 0.5%	Emerging Debt -8.8%	Europe ex-UK -0.7%	Emerging Equity -10.0%	Global Fixed 3.7%	Cash 0.2%	UK Equity -9.5%	Commodities 3.6%	Commodities -6.1%	Emerging Debt -4.4%
Commodities -5.4%	Commodities -11.2%	Commodities -11.9%	Commodities -20.3%	Cash 0.3%	Commodities -7.1%	Europe ex-UK -9.9%	Cash 0.6%	UK Equity -9.8%	UK Fixed -4.7%

Sources: SEI based on data from Bloomberg
Annual returns in GBP through 31 December 2021. 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 1/1/2012 and continues through 31/12/2021. 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 UK Series All Share Index (GBP), Emerging Debt = 50/50 JPM EMBI Global Div & JPM GBI EM Global Div (GBP), US Equity = Russell 3000 Index (GBP), Emerging Equity = MSCI Emerging Markets Index (Net) (GBP), Global Fixed = Bloomberg Barclays Global Aggregate Index, Hedged (GBP), UK Fixed = ICE BofAML Sterling Broad Market Index (GBP), UK Linkers = ICE BofAML UK Gilts Inflation Linked 5+ Yrs Index (GBP), US High Yield = ICE BofAML US High Yield Constrained Index, Hedged (GBP), Japan Equity = Tokyo Stock Exchange TOPIX (GBP), Europe ex-UK = MSCI Europe ex UK Index (Net) (GBP)' Commodities = Bloomberg Commodity Total Return Index (GBP), Cash = ICE BofAML British Pound 1-Month Deposit Bid Rate Average Index (GBP).

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