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Diversification: It's Not Always Easy to Do the Right Thing

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Snapshot

- Year in and year out, a single index will often outperform a well-diversified portfolio.
- Yet outperformance is difficult to predict—and over time, the diversified portfolio tends to perform well despite consistently falling short in any single year.
- Although it often leads to challenging conversations between financial advisors and investors, we believe diversification is the right approach.

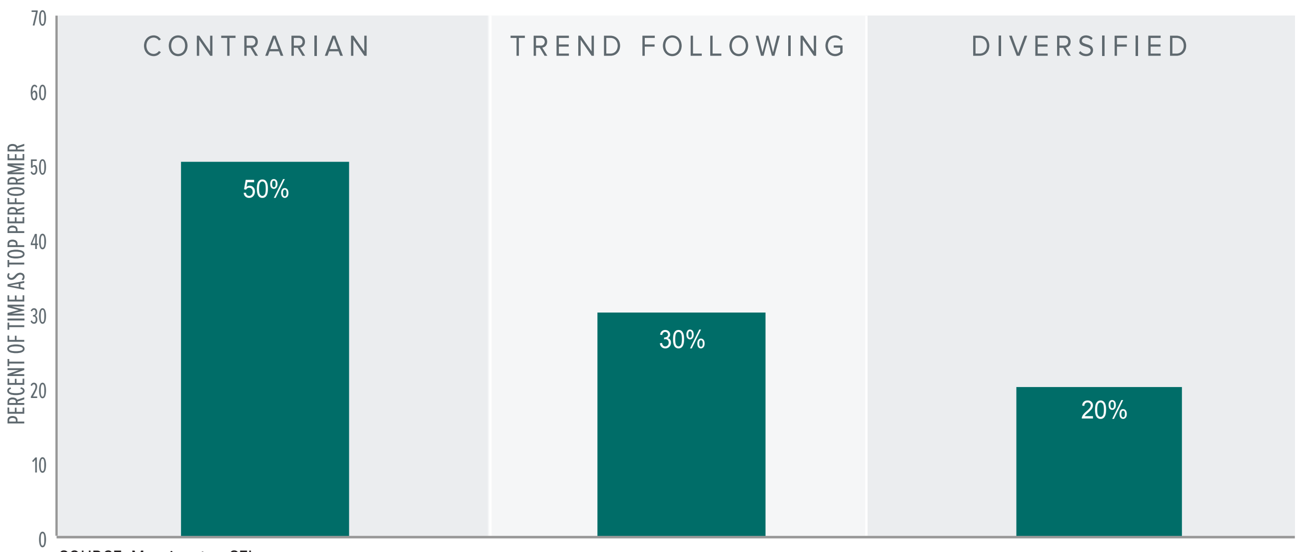
Everybody loves a winner

With the upward momentum in global stock markets showing no signs of abating, the traditional well-diversified investment portfolio has fallen out of favour. While diversification is a time-tested method of portfolio construction that has reduced risk (standard deviation) and delivered more consistent returns, it doesn't deliver the kind of attention-grabbing performance that has been making headlines. So, as is often the case during periods of strong equity performance, investors are generally left disappointed when comparing diversified portfolio returns with those of a single index.

Diversification rarely wins in any given year...

Many investors want to buy last year's winner; in the short-term, this strategy sometimes works well. Over the past 10 years, a trend-following strategy—one that invested in the top-performing asset class from the prior year—would have been the top performer 30% of the time. Meanwhile, a contrarian strategy—one that invested in the worst-performing asset class from the prior year—would have been the top performer 50% of the time. A diversified strategy that invested equally in each asset class would have been the top performer only 20% of the time.

All performance stated in GBP



SOURCE: Morningstar, SEI.
Past performance is no guarantee of future results. For illustrative purposes only and does not represent actual investments. Using index returns for asset classes utilised on page 3. Index returns do not include the effect of fees or expenses.

...But diversification also rarely lost

Looking solely at how often each strategy outperformed tells only part of the story. When considering the number of times each strategy was the bottom performer, we observe that the trend-following and contrarian styles finished worst 60% and 30% of the time, respectively. The diversified strategy finished last only once in 10 years, returning 14.4% in 2010—still a robust gain, above the long-term expected and historical average returns for a diversified strategy and nearly equal to the 14.5% gain registered by the contrarian style that year.

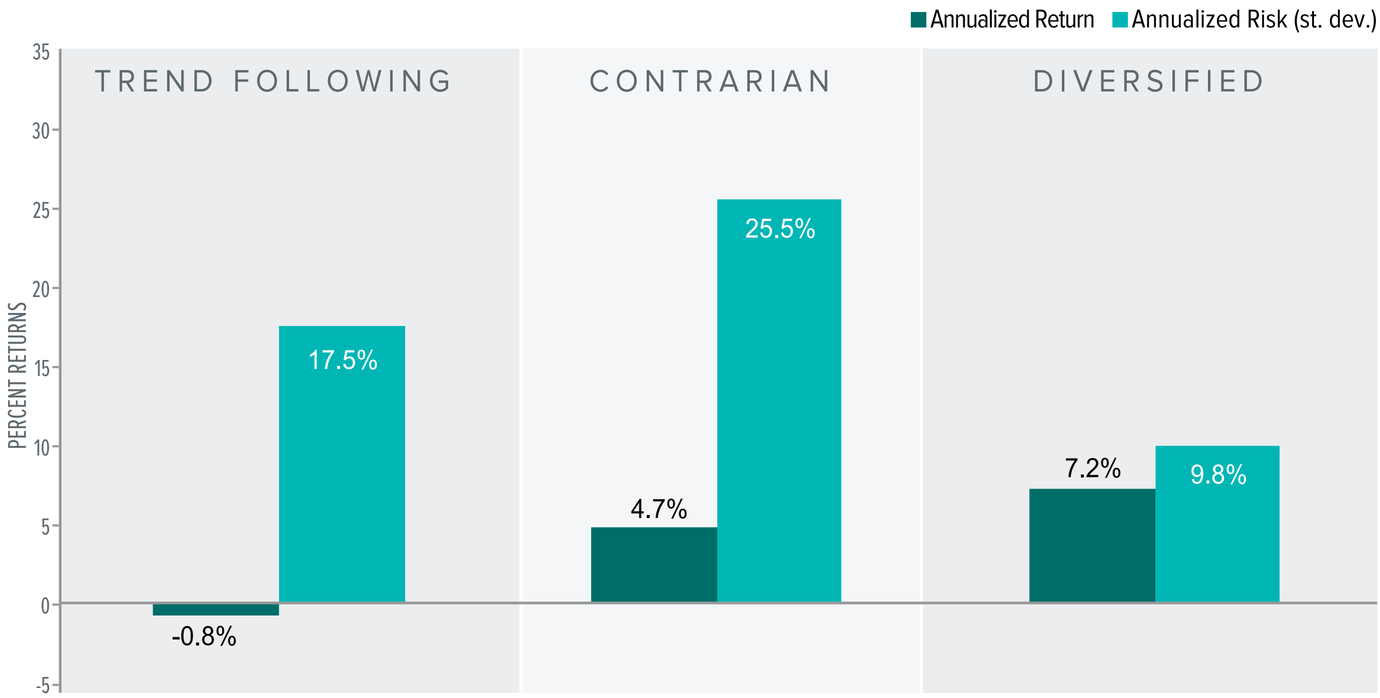
The proof

While the trend-following and contrarian strategies tend to have a greater opportunity to register headline-grabbing short-term outperformance, they also have the highest tendency to underperform. The diversified strategy may not have the same opportunity to achieve dramatic short-term gains, but it may help minimize significant losses in a given year. Over longer, multi-year periods, a strategy that successfully avoids significant losses will tend to outperform and experience less volatility. This is the reason responsible financial advisors recommend diversification as the right thing to do for their clients.

If we examine the most recent 10-year period as a whole, we observe that the trend-following strategy actually lost value despite being the top performer in three separate years. This resulted in an average loss of 0.8% per year and came with relatively high volatility of 17.5% annually. The contrarian strategy performed significantly better, gaining 4.7% annually, although with stunningly high volatility of 25.5%. The diversified strategy easily outpaced both, with an average gain of 7.2% and only 9.8% volatility. It's clear that the strategy with the most consistent returns came out on top in the long-term.

It's not always easy to do the right thing

Over the past decade, prudent financial advisors have had to defend performance of well-diversified portfolios in eight out of 10 annual client meetings. (See chart on page 1.) While this task may seem daunting, just imagine having to defend a trend- following emerging-market equities portfolio after it plummeted by 35.4% in 2008. The contrarian strategy presented similar challenges following consecutive losses of 11.2%, 11.8% and 20.3%, respectively, from 2013 to 2015 in a portfolio concentrated in commodities.



SOURCE: SEI/Bloomberg
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Chart disclosures

Asset-class returns are based on the same indices as indicated on page 4. Performance begins 1/1/2007 and continues through 12/31/2016. In each of these years, “Trend Following” uses the current-year return of 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.

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Emerging Equity 37.00%	Emerging Debt 23.30%	Emerging Equity 58.90%	Emerging Equity 22.60%	UK Linkers 23.30%	US High Yield 15.50%	US Equity 31.10%	UK Linkers 21.40%	Real Estate 13.80%	US Equity 34.50%
Commodities 14.30%	Cash 5.40%	US High Yield 57.00%	US Equity 20.60%	UK Fixed 13.50%	Emerging Debt 13.30%	Global Equity 21.10%	US Equity 19.60%	Emerging Debt 7.10%	Commodities 33.30%
Global Equity 10.10%	UK Fixed 4.30%	UK Equity 30.10%	Commodities 20.50%	Emerging Debt 9.30%	Emerging Equity 13.00%	UK Equity 20.80%	Real Estate 19.30%	Global Equity 6.80%	Emerging Equity 32.60%
UK Linkers 8.60%	UK Linkers 3.30%	Global Fixed 16.50%	Emerging Debt 15.60%	Real Estate 8.10%	Global Equity 12.80%	Real Estate 10.90%	UK Fixed 13.90%	US Equity 6.30%	Emerging Debt 31.40%
Cash 5.90%	Global Fixed -3.80%	Global Equity 14.80%	US High Yield 14.70%	Global Fixed 5.00%	UK Equity 12.30%	US High Yield 7.60%	Emerging Debt 12.10%	UK Equity 1.00%	UK Linkers 27.40%
UK Equity 5.30%	Commodities -10.90%	US Equity 14.30%	UK Equity 14.50%	US High Yield 4.10%	US Equity 11.30%	UK Linkers 0.60%	Global Fixed 7.90%	UK Fixed 0.50%	Global Equity 20.80%
Emerging Debt 4.50%	US Equity -13.20%	Emerging Debt 14.00%	Real Estate 14.50%	US Equity 1.80%	Global Fixed 11.10%	Cash 0.30%	Emerging Equity 3.90%	Cash 0.40%	US High Yield 16.90%
Global Fixed 3.60%	Global Equity -19.70%	Commodities 5.90%	Global Equity 10.90%	Cash 0.50%	UK Fixed 6.10%	Global Fixed 0.20%	US High Yield 2.70%	Global Fixed 0.10%	UK Equity 16.80%
US Equity 3.40%	Real Estate -22.50%	UK Linkers 5.60%	UK Linkers 9.00%	UK Equity -3.50%	Real Estate 2.40%	UK Fixed -2.60%	UK Equity 1.20%	UK Linkers -1.20%	UK Fixed 10.60%
UK Fixed 3.30%	US High Yield -26.50%	UK Fixed 3.70%	UK Fixed 7.90%	Commodities -12.70%	Cash 0.50%	Emerging Equity -4.40%	Global Equity 1.10%	US High Yield -4.70%	Global Fixed 5.80%
US High Yield 3.00%	UK Equity -29.90%	Real Estate 2.20%	Global Fixed 7.30%	Global Equity -14.10%	UK Linkers 0.50%	Emerging Debt -8.30%	Cash 0.40%	Emerging Equity -10.00%	Real Estate 2.60%
Real Estate -5.50%	Emerging Equity -35.40%	Cash 0.80%	Cash 0.40%	Emerging Equity -17.80%	Commodities -5.40%	Commodities -11.20%	Commodities -11.80%	Commodities -20.30%	Cash 0.30%

SOURCE: SEI, Morningstar

Asset class definitions

Asset categories represented by: UK Equity (FTSE UK Series All Share Index), US Equity (Russell 3000 Index), Global Equity (MSCI EAFE ex-UK, Net), Emerging Equity (MSCI Emerging Markets Index, Net), Global Fixed (Bloomberg Barclays Global Aggregate Corporate Index, Hedged), UK Fixed (BofA Merrill Lynch Sterling Broad Market Index), UK Linkers (FTSE Actuaries UK Index-Linked Gilts Over 5 Years Index), US High Yield (BofA Merrill Lynch US High Yield Constrained Index, Hedged), Emerging Debt (JP Morgan EMBI Global), Real Estate (IPD UK All Property Total Return Index), Commodities (Bloomberg Commodity Total Return Index), Cash (BofA Merrill Lynch British Pound 1-Month Deposit Bid Rate Average Index). Performance in GBP, data as of 31 December 2016.

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