Diversification In The Form Of A Variable Asset Allocation

Saturday's With Jim

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Dear Friends,

Diversification reduces risk of total loss but what is the impact of diversification on account returns beyond avoiding total loss? When markets rise, they are usually led by a vanguard – a few companies or industries that catch extreme investor interest. Concentration at the top can really get out of hand when an investing frenzy grips the populace as it did in 1926-1929 and 1997-2000. Those heavily invested in the market leaders did super well, others not so well during the run up. The aftermath was a different story.

Study after study the shows the long-term benefits of diversification. Yet humans can't see the long-term forest – only the trees of periodic checks on account balances. Falling behind the leaders for even a time creates anxiety for some and so they try to always stay with the leadership. Such behavior requires tremendous luck and agility. It's momentum investing at its best. The only problem with momentum investing is its tendency to fail quickly and mightily when investors pull out their money. A momentum investor must be adroit and agile – sensing the time when the plug should be pulled and then actually doing it. Momentum investors cannot fall in love with their stocks. What if there is another, better way, to reap reward in the markets without the perils and thrills of momentum investing?

Arriving At Diversification from a Different Angle

Diversification spreads risk of both gain and loss. Yet over time accounts that are diversified globally do better than accounts that are invested in only the investor's home market. The key to the outperformance is the low correlation between U.S. and many foreign countries. Global diversification reduces account volatility, too. So what is the mechanism?

High volatility lowers long-term returns for two reasons. The math of high volatility favors low to moderate volatility if long-term returns are to be optimized and, perhaps most importantly, most people are terrible at managing volatile securities because volatility tears at the emotions. Volatility enhances both feelings of greed and fear. We can reduce the zigzag effect of volatile investments by combining them with others whose movements are not highly correlated with them. Lowering volatility while increasing returns is investment's free lunch.

And so it is that we primarily diversify to smooth returns to help long-term return growth and avoid negative excitement over investments. But we don't stop there.

Tweaking Diversification to Enhance Returns

Like most other investors, we maintain a base allocation between stocks and bonds, between large companies and small companies and between the U.S. and international investments. We regulate the stock/bond mix according to the economic cycle, raising the bond allocation as the threat of recession rises to a high probability. We also have a base allocation for U.S. and international securities based on trend following, recognizing that the U.S. outperforms international investments over cycles of several years and vice versa. We overweight the U.S. when it is outperforming and reduce the overweight when international stocks are outperforming , which they are just beginning to do after an eight year drought broken only by occasional flashes of temporary outperformance. Our technique is surely not foolproof and it does rely heavily on discretionary judgment, but we never swing for the fences so to speak. Tweaking a bit here and there reduces risk (by exchanging overvalued securities for undervalued ones) and picks up a bit of a return premium by being slightly overweight in the area that is doing well.

So What?

The financial world is so complex that no one strategy works all of the time. Our underlying investment strategy is to combine "factors" like quality, value, momentum and low volatility that complement each other, ensuring that we are never completely out of step with the markets' general direction. But we will seldom be in complete sync with what the markets value at any given time, either. Our diversification strategy lays on the basic one. We don't tweak the quality focus much, but we do make adjustments to asset allocation (another word for diversification). We believe that paying attention to long multi-year market and economic cycles will reduce risk and make at least acceptable returns.