Volume 50 //

Acuity

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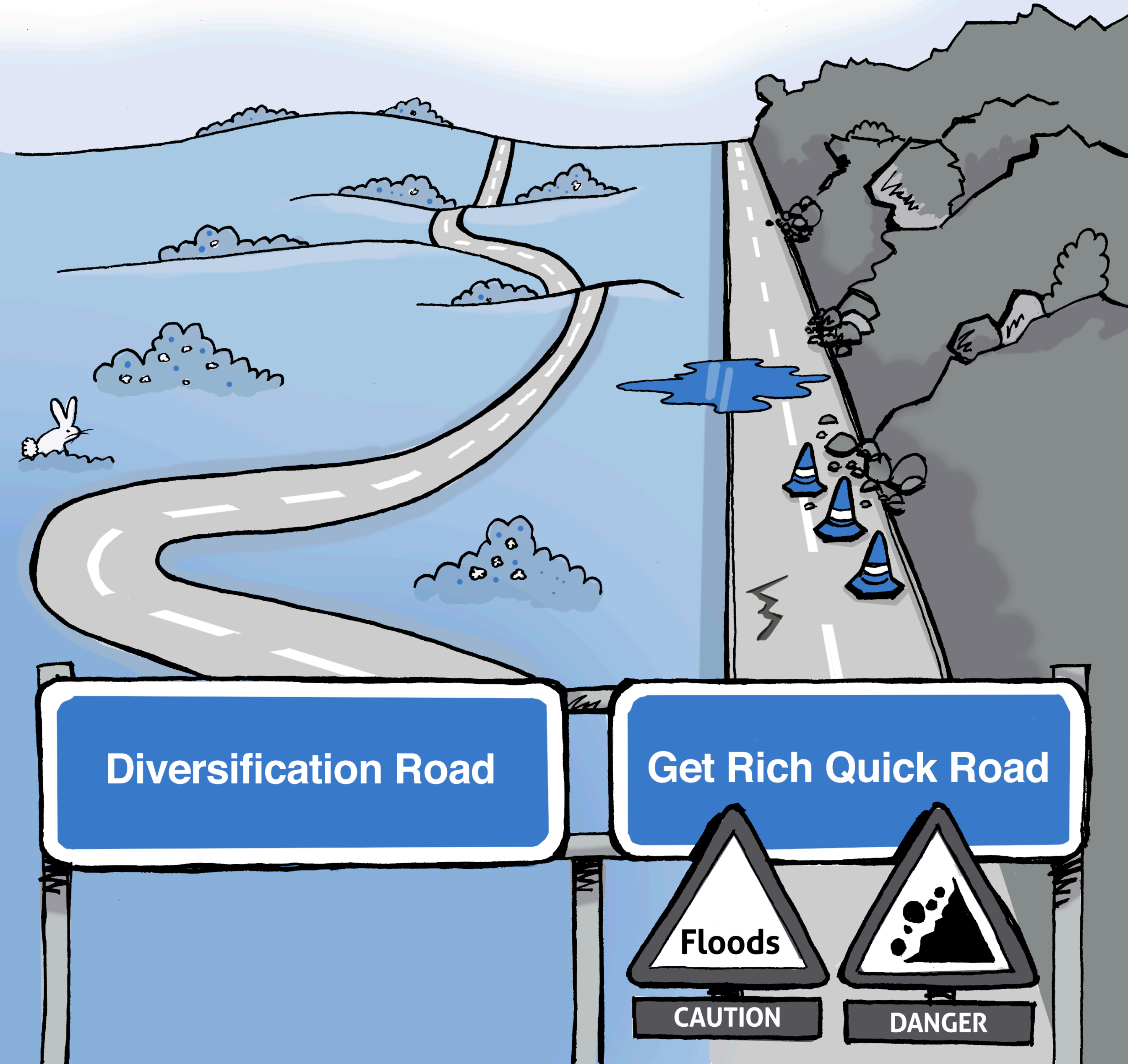
The pain and pleasure of diversification



“Diversification is always having to say you are sorry.”

Anon

Diversification sits at the heart of good investing. Diversified investors give up on the concentrated, high level exposure – and potential upside - of owning the next Amazon, hot sector or equity market. In return, they benefit from the aggregated returns of companies, sectors, and asset classes garnered across time. They avoid the prolonged and potentially deep pain of owning concentrated, poorly diversified portfolios. Don’t underestimate the powerful outcomes that this seemingly conservative approach delivers but be prepared to accept that in a diversified portfolio, some part of the portfolio will be performing poorly, at any one time. That is the price you pay.

Could’ve, would’ve, should’ve!

It is human nature to look at an investment that has done particularly well and wish you had been invested in it. We all risk being dragged into ‘if only’ mind games: ‘If only I had put £10,000 into Amazon in 2003, I’d be retired by now’[1]. ‘If only I had bought Bitcoin at £1…’

These thoughts are dangerous to investors, as this fear of missing out (FOMO) can tempt them into taking speculative risks, often based on a rear-view mirror perspective. Loading up on the FAANGs (Facebook, Amazon, Apple, Netflix and Google) in a portfolio would have earned rich rewards over the past 5 years. How tempting does it feel to ride that wave? Unfortunately, many investors seem to have forgotten the similarly meteoric rise of Cisco in the late 1990s leading up to the technology crash: at the start of 1995 Cisco’s share price was around \$2; by March 2000 it stood at almost \$80. Today it languishes around \$52, nearly two decades later. Enron, a similar success story of the 1990s, collapsed in late 2001. Concentrated risks have concentrated outcomes, both good and bad.

The figure on page 2 sets out the outcomes of several diversified and concentrated strategies over the past 5 years. Big return differences occur across markets, sectors, companies and managers. Diversification tends to hug the middle ground.

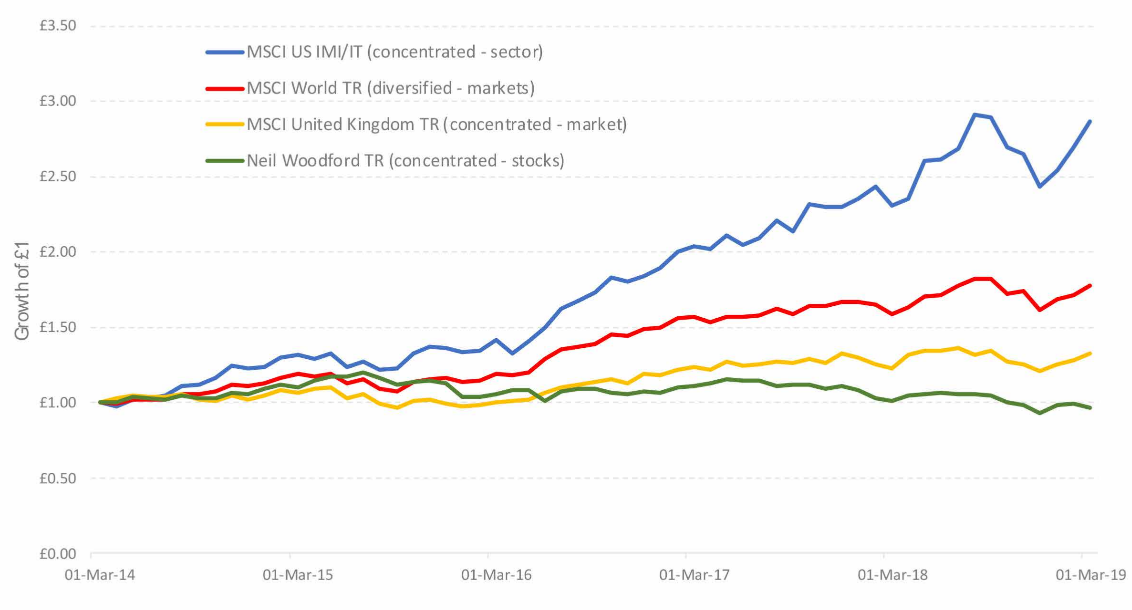


Figure 1: Outcomes can vary dramatically, such as over the past five years to end Q1 2019

Data source: Morningstar Direct © All rights reserved.[2]

Given that markets work pretty well – that is to say that they generally incorporate all available information into prices – taking a concentrated 'bet' constitutes a high stakes gamble. It is hard to forecast the future and very few professional fund managers have track records demonstrating an ability to profit from trying to do so persistently over time, particularly after their costs have been deducted. Neil Woodford was a highly respected fund manager, but anyone reading the news lately will have seen that his concentrated, high conviction, long-term strategy takes a lot of living with, which few investors seem to have the stomach for. His fund, which peaked at above £10 billion, has less than £4bn in it today and the doors are now closed to new money and withdrawals. Concentration risks are real.

A powerful insight into the dangers of owning a concentrated portfolio can be found in a piece of research on the US market from 1927 to 2015[3]. Of the 26,000 companies that have been listed on the US exchanges, only 36 made it through the whole period. The average life of a listed company was seven years. The total wealth of $32 trillion generated over the period was accounted for by just 4% of companies. Of course, picking these 4% would have resulted in unimaginable riches, but alternative concentrated portfolios of any other 4% of the market would have been another, less palatable story. The market as whole – the good and bad in aggregate – delivered an annualised return of nearly 7% i.e. investors doubled their money every 10.5 years, over this period. That's a pretty good outcome and a direct consequence of being diversified.

There are many professionally managed funds in the UK and other marketplaces that hold 30 to 50 stocks, with some sporting seemingly great recent performance and strong inflows of money. The astute reader will quickly see the risk of survivor-bias in the numbers and the possibility that luck may well have played a big hand in their success to date. It was not too long ago that Neil Woodford received similar high acclaim.

Eggs and baskets

The difficulties of trying to time markets or to pick companies, sectors or managers, in the face of little evidence that professional investors have persistent skill in these fields - for which we provide some compelling evidence later - suggests that a rational investor should eschew such approaches and seek to place their investment eggs across a wide range of baskets.

The figure below reveals the positive risk-reduction benefit that a diversified basket of developed equity markets delivers over owning one single market, such as the UK. You can see that the combined 'World' has a lower level of risk - measured on the horizontal axis – compared to all individual countries. The level of return is not as high as Hong Kong but is well above that of Italy. Picking Hong Kong in 1970 would have required a good dose of luck and a lot of stomach for the ups and downs one would have experienced. The World markets allowed investors to double their purchasing power every 18 years, which is not a bad outcome.

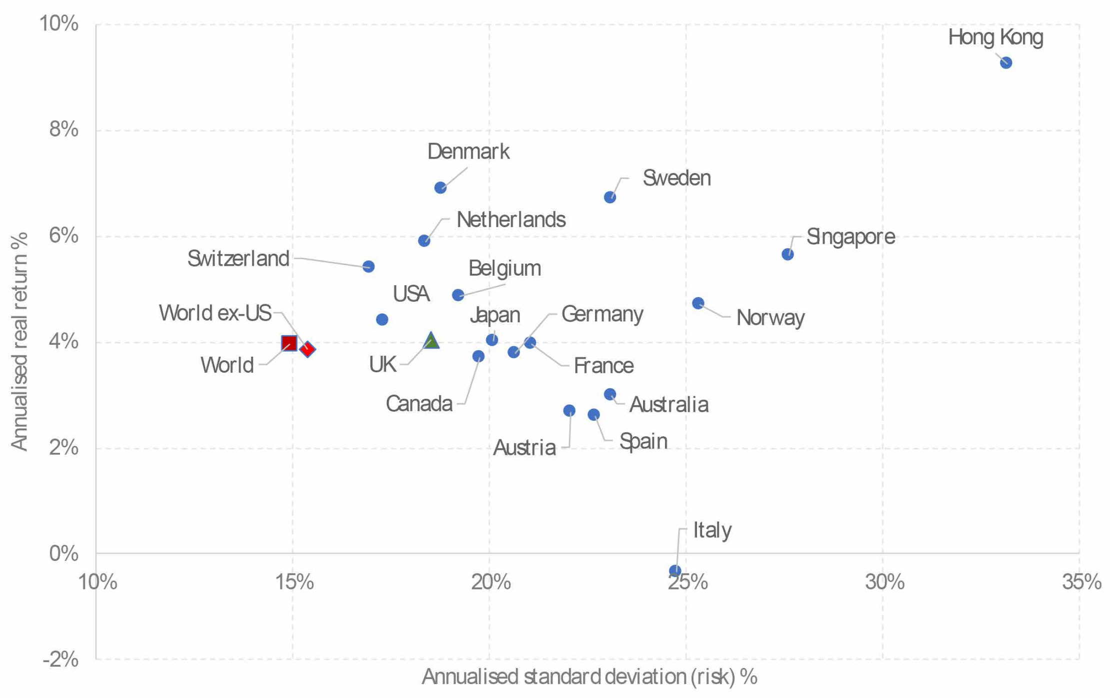


Figure 2: Individual countries vs. global market cap weighted portfolio (1/1970 to 1/2019)
Data source: Morningstar Direct © 2019. All rights reserved. MSCI country indices, net div. USD in GBP.

At a simple asset class level, being diversified makes good sense too. It is not a new strategy, as this passage from the Talmud, written in around 200 CE, states:

> ***'Let every man divide his money into three parts, and invest a third in land, a third in business, and a third let him keep by him in reserve.'***

The Talmud

Take a look at the figure below, which compares the annual returns of global equities (business), high quality bonds (reserves) and global commercial property (land) over the past 20 years. The first thing that is evident is that no predictable pattern of returns exists. The second is that the simple Talmud strategy (a simple 1/3 in each, rebalanced each year) results in a pretty good outcome and smoothed journey i.e. higher returns than equities with considerably lower risk.

																				Period	
1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Return	Risk
30%	34%	16%	7%	25%	25%	24%	22%	10%	9%	20%	28%	3%	18%	20%	30%	6%	28%	13%	1%	11%	17%
11%	11%	8%	-2%	20%	13%	23%	11%	7%	-12%	19%	17%	2%	11%	7%	14%	4%	29%	4%	0%	7%	9%
4%	8%	3%	-7%	17%	7%	17%	6%	1%	-20%	14%	16%	-1%	11%	1%	11%	3%	19%	0%	-1%	6%	14%
-2%	-7%	-14%	-27%	4%	6%	5%	4%	-13%	-24%	3%	2%	-7%	2%	1%	2%	1%	1%	-1%	-4%	4%	1%

= business = land = reserves = Talmud portfolio

Figure 3: Asset class outcomes appear to be random over the short term

Data source: Morningstar Direct © All rights reserved.[4]

Having to say you are sorry…

The challenge with owning a diversified portfolio is that sometimes investors fail to look at the big picture, diving into the detail of their portfolio valuation to pick out the fund that is not performing well, and possibly raising questions about it. Underperformance does not mean that it is a bad fund or a bad strategy or a bad manager, particularly when systematic, low cost funds are used in the portfolio to capture market returns. It just means that some markets (or parts of markets) are zigging while others are zagging – the very essence of diversification.

Let's take the case of value (less financially healthy) stocks, where the expected returns are higher than those of the broad market on account of the higher risks taken on. Over the past five years, global value stocks have underperformed the global markets by a little over 1% per annum[5]. The question the investor should really be asking is 'does the value premium still exist and is the fund structured to capture this premium when it does arise?'. That is a valid question, which requires an answer that relates back to primary thinking around why the asset class is in the portfolio in the first place. All assets go through good and bad times, hence the need to be diversified. The fact that the value premium has been negative is not unexpected, nor is the level of under-performance. Would investors give up on equities because over a 5- or 10-year period they fell below returns from cash? Most probably not, as owning companies is riskier than holding cash and should therefore have a higher expected return going forward. The same applies to the value premium.

In the US, the value premium has been negative in 16% of 10-year periods since June 1927. Following a 10-year negative average value premium, there has never been a subsequent 10-year negative period. In fact, between June 1927 and February 2019, the minimum 10-year value premium following a negative 10-year period was nearly 3% per annum. History may not repeat itself and there is no guarantee that the value premium will be positive simply because the previous 10 years has been poor, yet an investor in a diversified portfolio would probably do well to remain in value stocks, rather than bail out of the strategy.

The proof of the pudding is in the eating

If it were easy to decide when to be in or out of markets or which handful of stocks were going to be the next FAANGs, then one would expect that a large number of professional fund managers running funds that have the flexibility to invest globally, time markets, pick good funds and fund managers should be able to beat the market benchmark after costs. To test this out, a recent piece of research[6], plotted live funds available to UK investors against hypothetical portfolios combining two broadly diversified benchmarks (global bonds and global equities[7]). Return is on the vertical axis and risk is on the horizontal axis. The small, independent coloured dots each represent a single professionally managed fund.

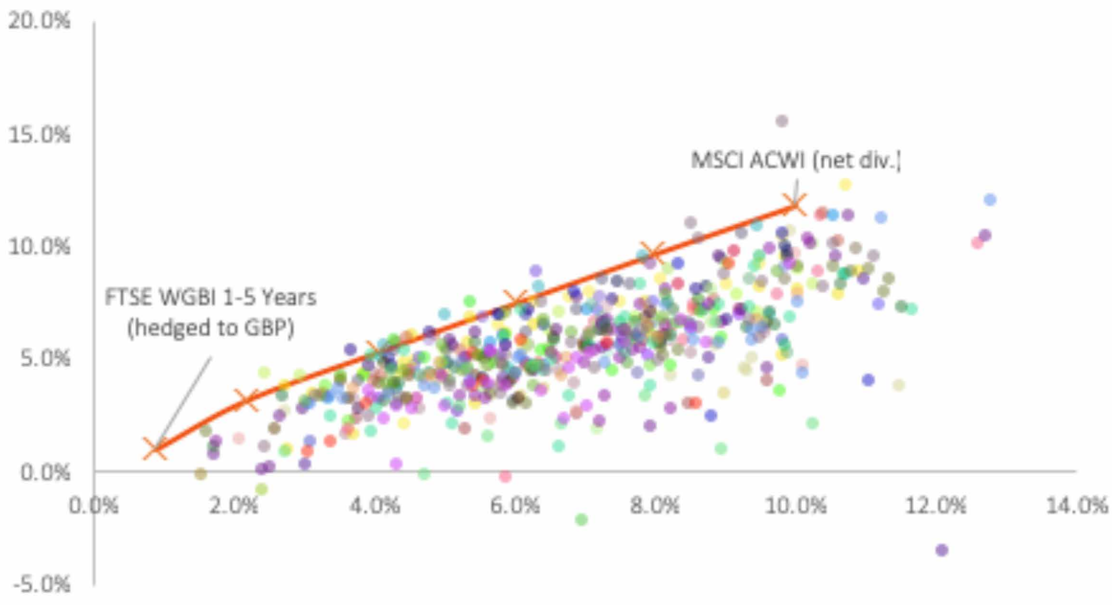


Figure 4: Professionally-managed funds versus simple diversified market benchmark portfolios
Data source: Morningstar Direct © All rights reserved.

As you can see, simply picking up the returns from a very widely diversified mix of assets dominates the vast majority of professionals whose goal it is to beat the markets. QED.

Conclusions

The obvious conclusions that can be drawn are that: markets work pretty effectively; no-one appears to have a material edge on forecasting markets and picking winning stocks and managers; costs drag down performance (the benchmark has no costs); and a broadly diversified market-focused portfolio is a sensible and lofty goal to seek. Concentrated sector, stock or market risks make little sense and give up the greater certainty of outcomes of a diversified portfolio. The origin and efficacy of a systematic, low cost, diversified portfolio capturing market returns is perhaps both evident and compelling.

A diversified portfolio is not always easy to live with, as there will always be something you don't own that is doing better than the portfolio and always something in the portfolio that is doing poorly. So, if your adviser sometimes has to say they are sorry about an underperforming fund always remember that a) they are not responsible for market returns and b) they are acting in your best interests by advising you to remain diversified and stick with the programme.

End notes

1. In 2003 Amazon's stock price fell as low as $7 per share. At the time of writing, the share price is over $1775
2. Neil Woodford data compiled from Invesco and Woodford track records.
3. Bessembinder, H., (2017) Do Stocks Outperform Treasury Bills? WP Carey School of Business, Arizona State University.
4. Data used: MSCI ACWI Index, S&P Global REIT Index, FTSE WGBI (0-5 years) Hedged to GBP. Talmud portfolio 1/3 in each asset class, rebalanced annually – no costs deducted. For illustrative purposes only.
5. Source: Albion Quarterly Market Metrics Q1 2019. MSCI World Index relative to Dimensional Global Value Index.
6. Albion Strategic Consulting © 2019. Data: Multi-asset fund families as defined by Financial Express Analytics.
7. The MSCI ACWI Index cover all developed and emerging markets in their market cap weights. The FTSE WGBI 1-5 years hedged to GBP includes high quality global government bonds with maturities between 1 and 5 years, where all currency movements are hedged to reduce the volatility of outcomes.

Other notes and risk warnings

Use of Morningstar Direct data

Risk warnings

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The registered office address of the Firm is 13 Portland Road, Edgbaston, Birmingham, B16 9HN

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