Diversification Isn't Dead

Why conventional wisdom is still your best long-term strategy

The extreme volatility of 2008 triggered broad-based market declines that caused some to question the value of diversification. While the performance link between various assets remains unusually strong, a more stable environment in 2009 has brought the value of combining different investments to reduce risk and foster positive long-term results back into focus.

The curious case of 2008

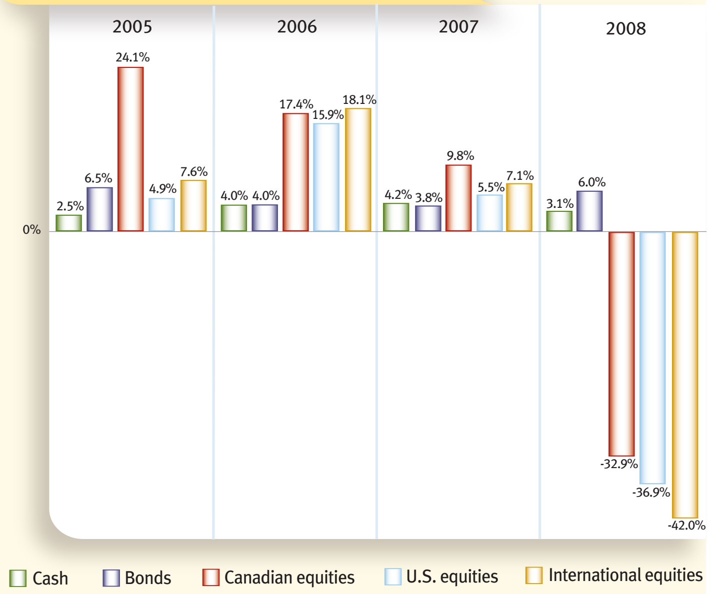
Since early March 2009, investors have been given reasons to be cautiously optimistic. However, this has also highlighted what an extraordinary year 2008 was. In an environment of fear and uncertainty, volatility reached historic highs and stock prices declined to multi-year lows.

Against this backdrop, a number of anomalous developments transpired. In fact, virtually all equity markets experienced declines (see chart to right). This undermined the conventional wisdom that holding a variety of investments (i.e., diversifying) should reduce overall risk and produce a smoother investment experience over time.

Since diversification has been a proven guiding principle for most investors, the atypical market action of 2008 caused many to second-guess their investment approach, which compounded the pain of seeing portfolio values shrink.

An unconventional year

During 2008, equity markets declined to a similar extent



Cash – DEX 91 day T-Bills, Bonds – DEX Overall Bond Universe, Canadian equities – S&P/TSX Composite Total Return Index, U.S equities – S&P 500 Total Return Index ($US), International equities – MSCI World Index

Correlation measures the strength of the relationship between two variables. Investments with returns that have historically tended to move in the same direction are said to be correlated and those with returns that move in opposite directions are considered uncorrelated.

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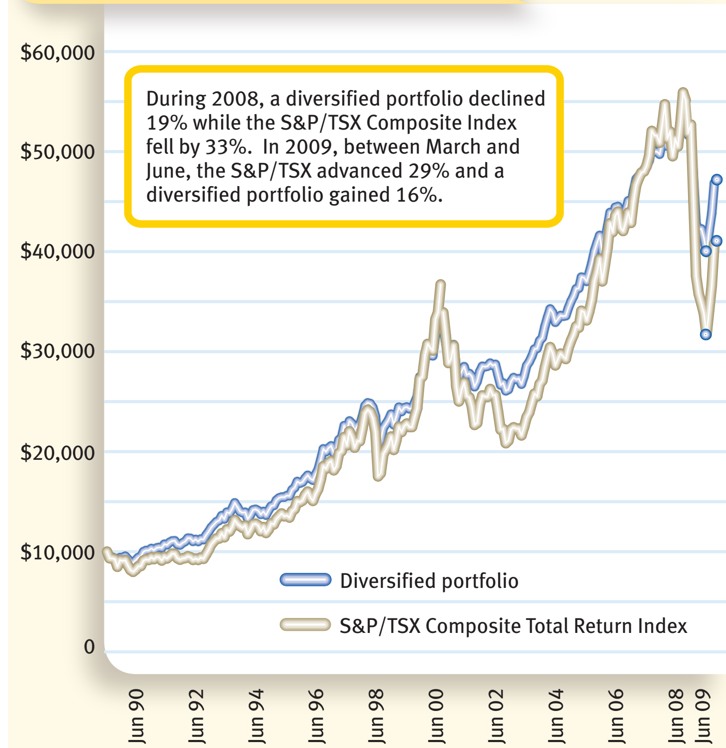
Hindsight is 50/50

What's important to understand, however, is that diversification cannot completely eliminate risk and will not always eliminate losses. Stock markets are cyclical and even properly diversified portfolios will be impacted by the reality that returns across different asset classes will vary and may be negative in some years, just as they may be positive during others.

But having a mix of different investments ensures that portfolios don't unduly suffer on the downside when markets are falling. For example, amid the worst financial crisis since the Great Depression, declines were very steep in 2008, but *diversification did what it was supposed to do*. As the credit crisis climaxed, a portfolio allocated across stocks and bonds (50% stocks and 50% bonds for example) would have limited the declines compared to losses in the broader equity market. What's more, the same asset mix would have captured some of the powerful rally in stocks that took place between March and June 2009 (see chart to right).

In addition to asset class, diversification can be achieved on different levels — including investment style, market capitalization, geographic region and industry sector. Within fixed income, risk can be mitigated by including bonds from different issuers (e.g., governments, corporations), with varying credit qualities (e.g., high yield, investment grade) and different regions (e.g., emerging markets).

Diversification worked, even when markets didn't



Growth of $10,000

In this example, a diversified portfolio consists of 50% S&P/TSX Composite Total Return Index and 50% DEX Overall Bond Universe

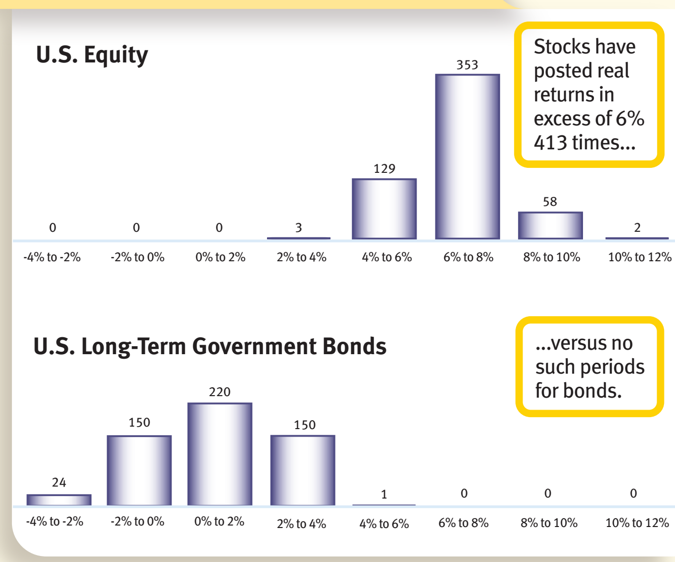
Beyond bonds

Another surprise in 2008 was the outperformance of government bonds. For example, 30-year U.S. Government bonds and long-term Government of Canada bonds returned 43.5% and 15.5% respectively in 2008. As investor risk appetite evaporated, demand for "safe" government debt securities jumped, pushing bond yields (which move opposite to bond prices) to multi-decade lows. At the other extreme, long-term equity returns became distorted by the significant losses that occurred in a matter of months as investors indiscriminately abandoned stocks. Some investors, whose faith in stocks had become shaken, looked at bond market performance and began questioning equity exposure altogether.

Drawing conclusions based on recent history, however, seldom leads to favourable outcomes. In portfolios, bonds play an important role by adding stability in volatile markets. Over time, however, building wealth requires the growth potential of equities. This is particularly true after inflation is factored in.

Over time, stocks have delivered higher real returns

There have been 545 rolling 40-year periods since December 1939



Source: O'Shaughnessy Asset Management

For example, looking at the historical performance of U.S. stocks and bonds over any 40-year period starting in 1900, equities have delivered higher "real" returns (i.e., after inflation) more frequently than bonds (see chart to bottom left). Specifically, of the 545 40-year periods, in 413 of them, or about three quarters, stocks posted returns above 6%. By comparison, there has been no 40-year span where bonds delivered real returns above 6%, and only once did they deliver returns in excess of 4% over this timeframe, after inflation.

A strategy for any market

In 2009, the global economy has started to show signs of recovery as massive and coordinated responses by global policymakers take effect. That said, the near-term outlook remains uncertain as significant headwinds exist. The fallout from 2008 will take time to clear.

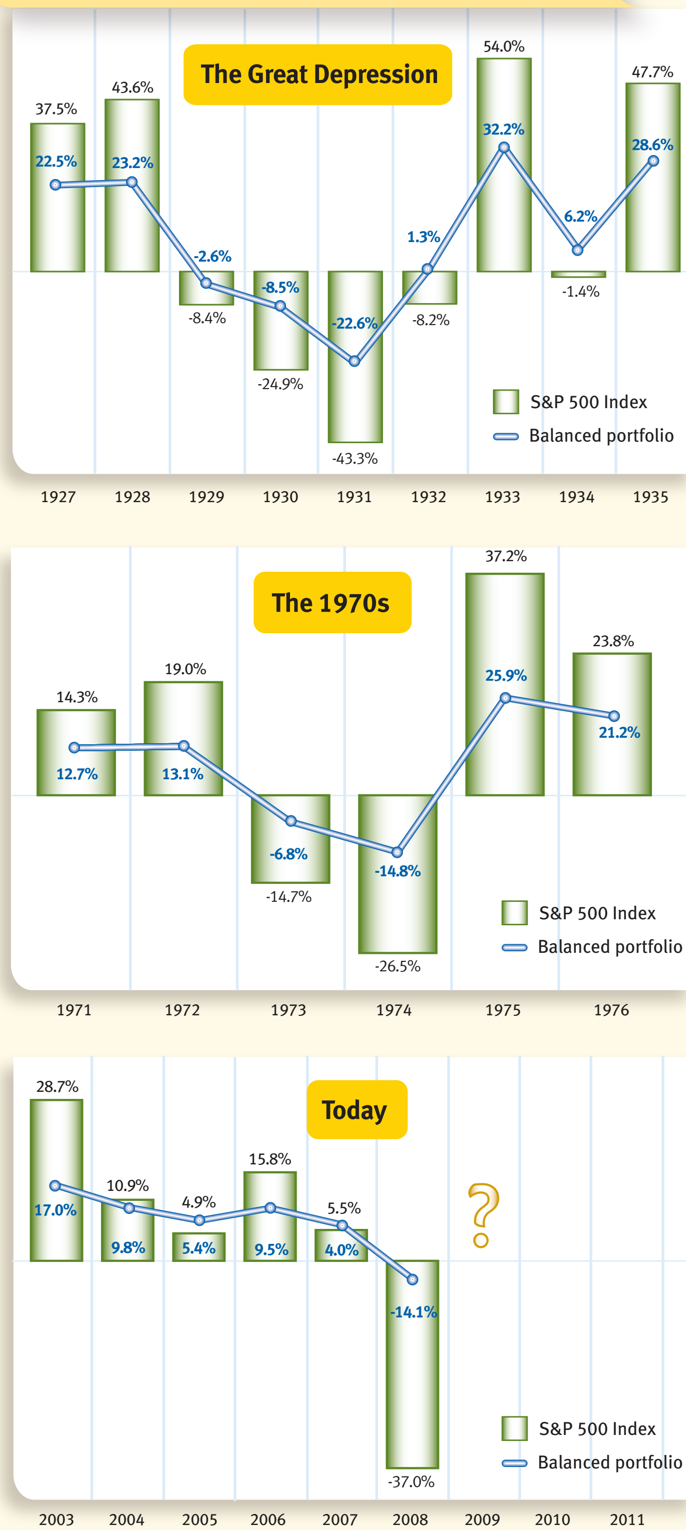
However, investors have faced similar environments in the past and during such times, diversification would have added value over the long run.

Since 1926, U.S. equities have posted one-year returns of more than 25% on 22 occasions and fell by more than 25% on 4 occasions, including a drop of 37% in 2008. In examining the data, and as the charts to the right highlight, during some of the sharpest downturns on record, a portfolio that was regularly rebalanced to maintain a 50/50 mix of stocks and bonds would have limited the impact of falling markets (although it would not have eliminated the risk). What's more, stocks have often bounced back strongly following steep downturns and a combination of equities and bonds, along with regular rebalancing, would have put a portfolio in a position to capture a meaningful portion of the subsequent comeback.

In today's uncertain environment, seemingly conflicting messages can complicate investment decisions. Whether you view the glass as half full or half empty, however, taking a balanced approach has historically been an effective strategy in any market environment. Although history is no indication of what might lie ahead, it has served as a reasonable guide. And given that 2008 was one of the most challenging years ever for stocks, it is prudent at this point to ensure that your asset mix is effectively diversified and appropriate given your long-term needs.

The portfolio of least regret

During some of the worst bear markets in history, a balanced portfolio significantly reduced the impact of a deep decline in equity markets, and regular rebalancing kept investors well positioned for recoveries.



Source: RBC AM. Based on a balanced portfolio rebalanced annually with an asset mix of 50% bonds (U.S. Long Term Governments) and 50% equities (S&P 500 Total Return Index).

What should you do?

The asset mix for many investors tends to become too aggressive during bull markets and overly conservative during or after bear markets. Recent history has highlighted once again, why disciplined asset allocation and an effectively diversified portfolio are key factors in achieving long-term success. Work with your advisor to determine if your current asset mix is appropriate given your risk profile, long-term objectives and where we are in the economic cycle.

What's more, it is necessary to revisit, rebalance and adjust your asset mix regularly as market conditions and your own personal circumstances evolve. Your advisor can help with this process and implement any changes that may be necessary.

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