MARKET INSIGHT

Diversification Has Not Lost Its Power

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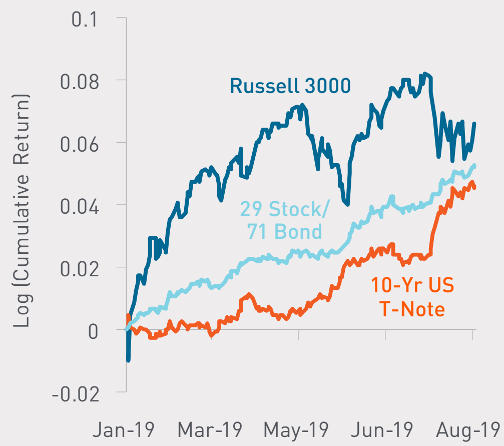
Diversification has been hailed as "the only free lunch" in investing. That is, by placing your bets on many assets with low correlations you can not only reduce the volatility of your portfolio, but also reduce the risk of significant losses. But from January to August 2019, stock and bond markets have both produced strongly positive returns. This has raised concern among many fund sponsors and investors. If all of my assets are up at the same time, has diversification lost its power? Does this mean that when the market corrects, they will all go down at the same time? At the extreme, some market pundits are asking, "Is diversification dead?"

Fortunately, diversification is still alive and kicking. While both the stock and bond markets are up on a cumulative basis this year, they took different routes on their way up. There is an old saying among mathematicians that "correlation is not causality." We can add to that saying, "cumulative returns are not correlation." In our view, this has been one of the best years for diversification. Both stocks and bonds have delivered strong positive returns, but with strong negative correlation. As a result, a hypothetical portfolio of stocks and bonds would have produced strong returns but at low risk. The overall Return/Risk (or "Sharpe") ratio of a balanced portfolio would be higher than a portfolio concentrated in either asset class. That's what diversification is about.

Figure 01 shows the cumulative returns of the Russell 3000 Stock Index and a continuous maturity 10-Year US T-Note (we show the charts in log space so the higher volatility of stocks doesn't drown out the bonds). As you can see, while both finished August with strong year-to-date gains, when stocks went up, bonds tended to go sideways or down; and when bonds went up, stocks were going down. In fact, over this time period, the daily correlation of the two assets was -59%, which is even more negative than the -35% experienced over the last ten years. We can also state that this -59% correlation is similar across daily, weekly, and monthly time scales.

FIGURE 01 - LOG CUMULATIVE RETURNS (JANUARY - AUGUST 2019)



Sources: Datastream

Figure 01 also shows a balanced portfolio of 21% stocks and 79% bonds. This is a typical low-risk portfolio for retirees and splits risk (as defined by standard deviation) between stocks and bonds. Table 01 shows that this balanced portfolio has realized a much higher Sharpe ratio than either stocks or bonds year-to-date. The traditional 60/40 portfolio also has a higher return/risk ratio than either asset separately. While this analysis focuses on the US, other developed markets show similar patterns.

So we can ask, "What is the causation for this low correlation?" It appears stocks and bonds are up for different reasons. At First Quadrant, we base our investment processes on the goals and preferences of market participants, and that plays an important role in the answer to this question. In 2019, it's likely that participants in the stock and bond markets have been interpreting the same information differently. The stock market this year has been chronically optimistic (particularly in the US), especially after the Federal Reserve became more dovish and began lowering interest rates. Stock investors reacted positively because lower interest rates could stimulate the economy and avert a slow-down or recession. Bond investors, however, were less enthusiastic. Although reduced borrowing costs could prop up the economy, if the Fed was worried enough to reverse its tightening plan, then the economy must already be fragile and the risk of a slow-down or recession is higher than the stock market thinks. Chairman Powell and other Federal Reserve officials have sent signals in both directions, citing a strong economy as well as risks to the economy. In our view, this difference of opinion across the two markets has contributed to the negative correlation.

TABLE 01: RETURN/RISK RATIO (JANUARY - AUGUST 2019)

	Russell 3000	10 Year T-Note	21/79[1]	60/40[1]
Return	14.99	9.65	11.39	13.12
Risk	14.04	5.57	3.63	7.34
Return/Risk	1.07	1.73	3.14	1.79

Source: Datastream

Whether the bond or stock market is right or not is debatable, but they can't both be right. In the end, the economy will keep growing or it will slow down. In either case, we would expect one asset class to continue climbing and the other to give back gains. But in both cases, we expect diversification to benefit portfolios. A simultaneous retreat is always possible; but it is not inevitable, and the causation for such an event is missing.

So in the end, diversification has not failed. Investors should not confuse positive cumulative returns with positive correlation. The underlying dynamics show that diversification is alive and well and will likely continue to work for investors when it's most needed.

Endnotes

[1]The 21/79 and 60/40 are hypothetical stock/bond portfolios used for illustrative purposes and are comprised of 21% MSCI World (local)/79% FTSE World Government Bond Index (local) and 60% MSCI World (local)/40% FTSE World Government Bond Index (local), respectively. The portfolios were rebalanced monthly and no trading costs were assumed.

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