



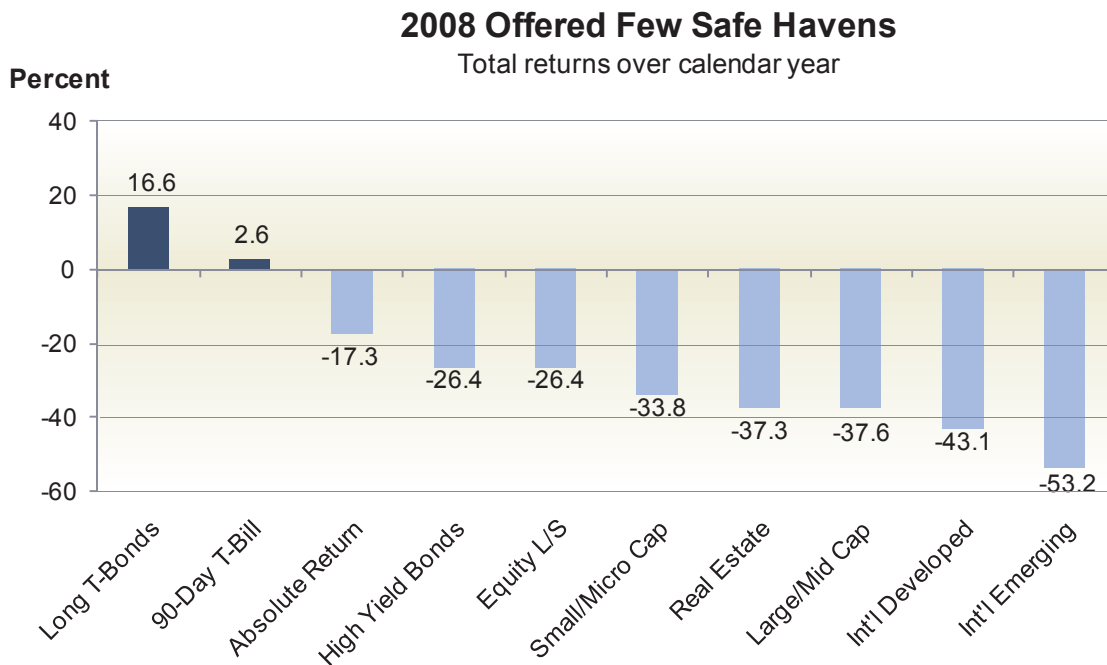
In Defense of Diversification

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INTRODUCTION

The severe bear market of 2008 caused many investors to question the value of diversification. Long a cornerstone of modern portfolio theory, diversification is the concept of managing the risk of your portfolio by spreading your investments among multiple, uncorrelated assets (correlation simply being a measure of the tendency for two investments to rise or fall in value together). By holding a diverse portfolio of uncorrelated investments, it is widely believed that investors could protect the value of their portfolios from the full onslaught of bear markets.

On the surface, diversification didn't seem to provide a meaningful level of protection from the bear market of 2008. In fact, among major asset classes only cash and U.S. Treasury bonds held their value during the year. Even holding assets outside the U.S., such as international equities, failed to meet the expectations of investors (see chart below).



Source: Zephyr Style Advisor, Vestek

Facing dismal performance nearly universal across asset classes during the crisis, many investors lost confidence in the value of diversification and thus lost confidence in their strategic allocations which are based in part on the concept of diversification.

In truth, the benefits of diversification are alive and well today as they were before and even during the crisis of 2008 (although it largely failed to help investors that year). Much of the confidence lost in the power of diversification to manage portfolio risk is actually driven by a common misunderstanding of the role of diversification in portfolio construction.

Diversification is a risk management tool and like all tools, it performs well at some tasks but not every task. A vacuum cleaner may do a great job of cleaning your carpet but would likely fail miserably at cleaning your windows. The reason, of course, is that the process of cleaning carpets is very different from the process of cleaning windows. You simply need different tools for the different jobs.

■ Viewing Risk as Exposure to Factors

Risk is a complex concept and not easily defined by even the most thoughtful investors. Risk can mean very different things to different investors or even to the same investor at different points in his or her life. Within the investment industry, however, variation in returns is the default risk metric. A key advantage of measuring risk in this way is that it allows investors to break risk down to the simplest components or factors possible. These factors may then be modeled in isolation when attempting to forecast the potential risk or the return of an asset.

For example, the total risk of holding a share of Ford stock can be broken down into its unique factors. These factors might include the growth rate of the global economy (since Ford sells to customers around the world), the risk premium or price of risk (the expected compensation that investors demand for holding risky assets such as equities), availability of consumer credit, decisions made by Ford's senior management, gasoline prices, along with many other factors. The relative strength in each of these factors contributes to the variation of the returns generated by Ford stock. Strong economic growth, a declining risk premium and easy consumer credit would each suggest that the price of Ford stock would rise.

■ Idiosyncratic Risk Factors versus Common Risk Factors

Different investments have different exposures to risk factors. A share of Procter and Gamble (P&G) stock, for instance, would not be affected by each of the same factors or in the same way as Ford stock. P&G's sales of toothpaste and cleaning supplies are much less dependent on the availability of consumer credit than are Ford's sales of automobiles. Likewise, decisions made by Ford's management team regarding how they should deploy the firm's resources have virtually no impact on the price of P&G's stock. By the same logic, decisions made by P&G's management team should not meaningfully impact the price of Ford stock.

Factors such as management decisions are largely idiosyncratic or specific to each firm. If we broaden the discussion from two stocks to the universe of investable assets, the same logic applies – each investment has some risk factors that are largely idiosyncratic or specific to that investment. It's this type of risk that is best managed through proper diversification of an investment portfolio. Holding a mix of investments that have uncorrelated specific risks such as management decisions greatly reduces the risk that a blunder by a single management team (remember the Edsel?) will lead to catastrophic returns at the total portfolio level. This is where diversification truly shines as a risk management tool.

Obviously, not all risk factors are specific to one investment. Some factors will affect many different investments or even asset classes in the same way or to a similar degree. These are referred to as common or systematic risk factors as they are common to many investments – even if the investments themselves appear to be quite different from one another on the surface. The benefits of diversification decline as the number or relative importance of common factors increase. Diversification is simply not a strong tool for managing common risk factors given that correlations will rise as the impact on returns from common factors increases.

■ When is a Portfolio Diversified?

Imagine a portfolio comprised of equally sized allocations in three asset classes – domestic real estate investment trusts (REITs), high yield corporate bonds and domestic equities. On one level, there is a degree of diversification as the portfolio has exposure to real estate, fixed income and equities. While this is true, the same portfolio also has several common risk factors including the strength (or lack thereof) of the U.S. economy and corporate earnings. The importance of the strength of the U.S. economy is easily seen as each asset class is domiciled in the U.S. and a rising economic tide will lift each of these domestic boats. Exposure to corporate earnings may be less clear given that only one third of the investments are in stocks.

But if we dig a bit deeper into the risk factors of high yields bonds and REITs, it's easy to see how corporate strength or weakness would have a material impact on the returns available from these asset classes. High yield bonds are issued by corporations with below-investment-grade credit ratings. As corporate earnings rise, the ability of these corporate issuers to make their payments increases and default rates should decline. Rising corporate earnings tend to increase the price of high yield bonds which means that corporate earnings are a contributing factor to the performance of these bonds along with other factors such as changes in yields.

In the case of REITs, we need to keep in mind that investments in REITs are not direct investments in real estate properties but rather firms that hold real estate properties. Further, these firms are traded along with equities on stock exchanges and even included in the construction of broad equity indices such as the S&P 500 Index. Therefore, there is a real estate factor that contributes to the returns available from REITS but there is also an equity market or corporate earnings factor and it too may have a significant impact on the value of REITs.

Each of these assets has some idiosyncratic factors as well as some common factors. The more significant the common factors in determining returns, the less effective diversification will be at providing downside protection should these common factors suggest lower asset values in the future. In other words, diversification fails to manage total portfolio risk when common factors drive the lion's share of the variation in returns.

So What Went Wrong in 2008?

With the advantage of hindsight, it's clear that a single factor – the risk premium or the compensation that investors expected to receive as compensation to hold a risky asset over a safe asset – common to all risky assets around the globe was mispriced leading into 2008. When the forecasted risk premium is low as it was in 2007, investors demand less compensation to invest in a risky asset such as equities rather than a low-risk asset, such as cash. Purchasing a risky asset when the compensation for taking risk is low opens investors to the possibility of capital losses should the compensation investors demand for taking risk increases toward the long-run run normal.

Risk premiums may range far from the long-term averages but they also tend to revert back to the mean. From 1923 through 2009, the historical 12-month rolling risk premiums measured by comparing the returns of the S&P 500 Index and U.S. Treasury bonds averaged about 8.25% but spikes and troughs have been quite common. Importantly to our discussion here, however, the risk premium always reverted back toward the mean following these sharp movements.

As the credit markets seized and many investors with very significant levels of leverage needed to raise capital very quickly, there was a mass rush to sell risky assets. Risk is a factor that is common to virtually all investments – even cash and U.S. Treasury bonds to an extent – and the market values of nearly all investments fell as risk was re-valued to near its long-term historical level.

Diversification did not offer much protection during the 2008 bear market as risk was the single factor that proved most dominant in determining investment returns and was endemic to nearly every investment. Diversification is not adept at helping in these instances when a single factor drives the performance of the capital markets. In fact, the only way to have meaningfully protected a portfolio from losses in 2008 was to have avoided holding risky assets before the crisis began. It might be cold comfort to realize that diversification didn't actually fail investors during the crisis (rather it was not the correct tool for the job) but diversification can still benefit long-term investors in most market environments.

The investment landscape of 2008 was quite unique and it was the rare investor who was well positioned to take advantage of this environment. Capital markets are largely efficient and thus periods in which the re-valuation of a single factor drives the performance of nearly every asset class are uncommon. The good news is that environments in which diversification does add value – when multiple factors and idiosyncratic factors meaningfully contribute to the relative performance of assets – are far more common than the periods in which the opposite is true. This is shown in the following table where the correlations measured between U.S. equity, high yield bonds and domestic REITs spiked to 0.90 (correlation coefficients fall between -1.0 and +1.0) and 0.83 respectively in 2008 but were significantly lower when the previous nine years are added to measure the correlations over a full decade.

Correlation Coefficients*

Asset Classes	Time Periods Measured		
	2008	2000 - 2008	Jan 1988 - Feb 2010 ***
U.S. Equity to High Yield Bonds	0.90	0.64	0.57
U.S. Equity to Domestic REITs	0.83	0.60	0.53
Risk of Equal Blend of Stocks, High Yield Bonds and REITs**	27.2%	14.4%	11.5%

Source: Zephyr Style Advisor

* Correlation coefficient is a measure of the correlations between any two assets over a selected time period. Correlation coefficients range from -1.0 to 1.0. A correlation of 1.0 suggests that the two assets move together as one while a correlation of -1.0 suggests that the movement of one asset exactly offsets the movement in the other.

** Annualized standard deviations based on monthly returns, assuming annual rebalancing of asset weights.

*** The longest time period for which High Yield bond data is available.

The relative importance of common factors such as economic growth or the risk premium in generating returns can cause correlations to rise or fall sharply – thus weakening or enhancing the benefits of portfolio diversification - over short time periods. Over longer time periods, however, correlations tend to cling to their historical averages leading us to believe that diversification will continue to benefit long-term investors in most investment environments.

What Does the Future Hold?

As long-term builders of wealth, will we face another crisis in the future? I will be surprised if we do not. The difficulty is predicting when and what the crises of the future will be given that by their very nature, they are surprises. For this reason, at Laird Norton Tyee we are continuously improving our investment and valuation tools to better predict and respond to market dynamics which may lead to a crisis. This is the rationale behind our efforts to be nimble and tactical as the capital markets evolve and the opportunities available to investors change.

We continue to recognize the importance of selecting and sticking with a strategic asset allocation that is appropriate for each of you as a proxy for the returns and level of risk that you may expect over your investment horizon. It's important to note that while we need to be prepared for bumps in the road, we cannot resort to investing from a base of fear and structure our portfolios only to protect us from losses while missing out on gains. While we do not suggest a simple buy and hold strategy based on your strategic mix, it provides a useful strategic base from which we can apply tactical positions that incorporate relative valuations and market trends along with the benefits of diversification.

As Mark Twain once penned, “The cat, having sat upon a hot stove lid, will not sit upon a hot stove lid again. But he won’t sit upon a cold stove lid, either.” Over reasonable investment horizons, investors who have made wholesale swings in their asset allocations or who hoarded cash in fear of investing in risky assets altogether have largely underperformed investors who have maintained the courage to remain committed to their strategic targets. We continue to recognize the value in sticking close to a strategic asset allocation that is appropriate for each client while taking correctly sized tactical or shorter-term positions around this strategic base as opportunities present themselves.

“ The cat, having sat upon a hot stove lid, will not sit upon a hot stove lid again. But he won’t sit upon a cold stove lid, either. ”

- Mark Twain

Meeting your investment needs and objectives over the long haul requires us to utilize the best tools for each job. It also requires us to avoid overreacting to a crisis. Many investors responded to their large portfolio losses in the bear market, driven by a re-pricing of risk, by significantly reducing the level of risk in their portfolios. The result was that they missed the very strong market rebound in the last ten months of 2009, which was led by riskier assets. Alternatively, investors who maintained a strategic mix of assets based on well-established concepts of portfolio construction enjoyed very strong returns during the last year.

At Laird Norton Tyee, we continue to utilize a time-tested building block approach to portfolio construction. Diversification plays a key role in this approach although it certainly is not the only tool we bring to the task. We appreciate the need to incorporate relative valuations, investment momentum and other factors into a tactical strategic process that is combined with our building block approach to strategic targets. A deep understanding of the capital markets and investment judgment must also be applied to both ensure that the correct tool is applied to each task and to understand the limitation of each tool in designing investment portfolios that help us meet our clients' objectives.

■ ABOUT THE AUTHOR

Robert Benson is Chief Investment Officer at Laird Norton Tyee. He is responsible for setting and implementing investment strategy at the firm as well as selecting managers for our client portfolios. Bob has nearly 20 years of experience in the financial industry, most recently at Russell Investments, primarily in investment strategy, asset allocation and risk management. He received his CFA designation in 1997, and he's a member of the CFA Institute as well as the CFA Society of Seattle. Bob has served on the boards of both start-up firms and non-profit organizations.

■ ABOUT LAIRD NORTON TYEE

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