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Traders work on the floor of the New York Stock Exchange. Stocks and bonds frequently move together, so investors need exposure to alternative investments such as distressed debt and infrastructure investments, a new study says.

Diversification doesn't always work, study says

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Stocks, bonds often move in same direction

By David Pett

Diversification remains one of the cornerstones of successful investing, but it comes with a slight hitch: It doesn't always work — at least not in the traditional sense of the theory, says Christopher Geczy, academic director of the Wharton Wealth Management Initiative.

"Investors need to think hard about portfolio construction and the risks they are taking in their portfolios, because the fact is that diversification is not as obvious as many may have thought, although it's also not abstruse," he said in a recent BlackRock Inc. report. "They may believe that they are diversified and exposed to different types of risks, but they may not be."

Modern portfolio theory, which advocates a diversified mix of stocks and bonds, has come under attack since the financial crisis of 2008 because rising correlations within and between those asset classes have diminished the strategy's main benefit, namely, better returns and lower risk.

Mr. Geczy said an undiversified portfolio of large-cap U.S. stocks and broad-market U.S. bonds actually performed slightly better than a more diversified portfolio that also included a range of other stocks and bonds during the recent downturn.

Based on his research, increases in correlations between stocks and bonds are common in times of market stress and extreme volatility, but they can also be quite high during full market cycles as well.

In the two significant bear markets of the last 10 years, the correlations between many individual investments and asset classes spiked closer to one, which represent a "perfect correlation," he said.

Furthermore, the correlation of returns between a 60/40 portfolio and a 100% equity portfolio was 0.99 during the past 15 years. A portfolio exceptionally overweight in bonds shows a similar trend.

"To me, that says that a long-only stock and bond portfolio isn't full diversification," he said.

To remedy matters, Mr. Geczy believes investors need to start thinking in terms of risk diversification, or getting exposure to as many different and non-correlated types of risk that they can through alternative investments such as arbitrage strategies, distressed debt and infrastructure investments.

"Trading commodities futures contracts, for example, and gaining the ability to go long or short such a contract, could provide a potential source of return that is diversified from traditional long-only assets," he said.

> The objective should be exposure to a variety of risks

"Certain currency trades would be another example. Going long the U.S. dollar and short the Japanese yen at certain times, for instance, can provide diversified risk to a portfolio."

Institutional investors including Ontario Teachers' Pension Plan and Canada Pension Plan are well versed in building diversified portfolios using alternative investments. Retail investors have been slower to embrace them, but a growing number of alternative mutual funds and exchange-traded funds are changing that.

John Nicola, chief executive officer at Nicola Wealth Management in Vancouver, said he has used a diversified asset allocation model using alternative assets including mortgages, real estate and private equity since 1994. Typically, his clients' portfolios have no more than 30% in equities and have earned a net-of-fee return of about 6.5% over the past 12 years. Returns for 60/40 equity/fixed income portfolios have been about 2.5% after fees during that same time frame.

"There are key asset classes that we feel need to be part of a truly diversified portfolio," he said. "Furthermore, we feel it is important that most if not all asset classes generate a reasonable percentage of their total return from the income or cash flow they generate."

Despite the growing evidence of their merits, many investors continue to view alternative investments as being highly volatile and not worth the risk. Mr. Geczy said that can be true, but just as often they provide less volatility, risk and, ultimately, an important new source of diversification.

"The objective for investors should be exposure to a variety of risks, in proportion to their risk preferences and circumstances," he said. "In short, investors should try to own as many different asset classes that have as many different types of risks as possible."

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