JOHN D. DOVICH & ASSOCIATES, LLC

The Reason for Diversification

-By Andy Bruns, CFA®

<u>The Reason for Diversification</u>

Don't put all your eggs in one basket, an axiom that we have heard countless times. I would argue that when it comes to investments, however, we should not put *just* eggs in our baskets. We tend to unknowingly diversify most things in our lives. Our wardrobes don't contain ten of the same identical outfits, and we don't eat the same meal for dinner every night. We crave variety in our daily lives. Our investment portfolios should have variety as well.

A well-diversified portfolio is crucial for long-term financial success. Chasing the latest hot investing idea or trying to "time" the market is not a replacement for strategic investment planning. In fact, over the last 20 years, if you had remained invested in US large cap stocks, your portfolio would have returned 7.7% annually. If you had missed just the 10 best days during that period by being out of the market, your return would have suffered by 3.7% annually[1]. Diversification will help you to weather market cycles and stay invested.

<u>How It Starts</u>

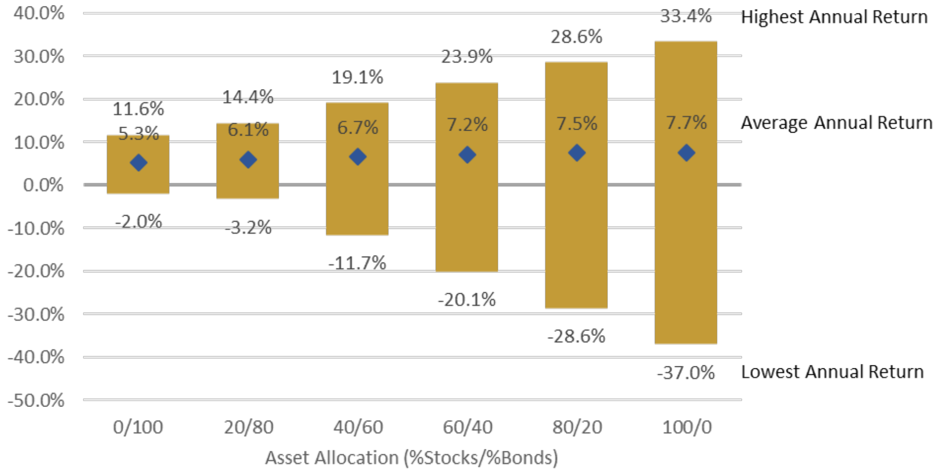
Let's go back to the wardrobe scenario and assume that it does not contain just ten identical outfits. Before you even open it, I imagine you already know what you are looking for since you already asked yourself "What occasion am I dressing for, and what is appropriate for the event?" More than likely you already ruled out shorts for that black-tie event.

Portfolio construction works in the same manner. Whether you are working with an advisor or on your own, you need to answer a series of questions. What is my financial situation? What is my tolerance for risk? When will I need money from the portfolio? Do I plan on leaving a legacy to the next generation? What sort of risks do I already have exposure to?

The answers to these questions start the groundwork for the portfolio's construction by allowing for the risk/reward objective to be created. In the realm of investments, risk has historically driven the returns of an asset class. The greater the risk, the greater the potential reward, but more often than not, the bumpier of a ride.

<u>Broad Asset Allocation</u>

From this risk/reward objective, an appropriate asset allocation is formed. On a broad level, this is the amount of stocks, bonds and other investments that constitute the portfolio. Figure 1 shows the highest and lowest annual returns, along with the average annual return, for a variety of allocations consisting of stocks and bonds over the past twenty years.



Graphic created by John D. Dovich & Associates, LLC.

Figure 1. Stocks are represented by the S&P 500 Index and bonds by the Barclays US Aggregate Index. Return data is for the period 1997-2016 and assumes annual rebalancing of portfolios at year-end.

As represented in Figure 1, different allocations can have vast return swings year-over-year. This could be as little as a 14% dispersion with a 100% bonds allocation or as much as a 70% dispersion with a 100% stock allocation. It is important to keep this in mind when determining asset allocation.

Are you able to emotionally handle large swings in your portfolio's value? If not, then an aggressive portfolio allocation may not be for you. Over the past twenty years a 60% stock/40% bond portfolio returned only 0.5% less annually than a 100% stock portfolio. Are you the type of investor that has the appetite for additional risk for incremental reward?
Your allocation is something that you need to stick with. If you are unable to stay fully invested when the market takes a downturn, you will eventually miss out on the subsequent rally. If the stock market drops 20%, will you be tempted to liquidate your holdings or buy into that weakness?

Do you need a more stable return pattern for your financial situation? An individual who is thirty years away from retirement can handle more market volatility than someone who already has cash flow needs. During the distribution cycle of a portfolio, assets should shift to a more conservative allocation to mitigate the impact of the withdrawals.

Underlying Diversification
By now we know the event, we have deciphered the dress code, and all that is left is to pick the individual clothing articles. Shirt color? Bow tie? French cuffs? Oxfords or wingtips? Just as individual pieces and separate decisions go into your outfit, the same occurs in an investment portfolio.

At this point, we know the overall allocation and just need to construct the underlying investments. Earlier we used a simple mixture of the S&P 500 Index and Barclays US Aggregate Index for our stock and bond allocation, but the decision is more complex than that.

On the equity side, do you use just large cap? What about small and mid-cap? Value or growth? Should you include international and if so, should there be an allocation to emerging markets?

On the bond side, do you use just taxable bonds or include municipals? Short-term or long-term bonds? What exposure do you want to credit sensitivity?

Each decision comes with its own risks. In any given year, there can be wide dispersion between asset classes and styles. However, by diversifying across various asset classes, you can mitigate volatility and add value to the portfolio. By analyzing excess return per unit of risk, we can see if the addition of an asset class is beneficial to the portfolio.

More importantly though, a judgement call is needed to see if an investment is appropriate for an investor. For example, an investor with liquidity needs may not be suitable to an investment in private equity or a hedge fund due to their lock-up periods. Likewise, a real estate investment trust (REIT) may not be appropriate for an investor who already owns a large amount of real estate.

Additional Considerations

As stock returns tend to outpace the returns on bonds, periodic rebalancing is critical to ensure that the portfolio is not taking unnecessary risk. Using our simplistic portfolio consisting of the S&P 500 Index and the Barclays US Aggregate Index, if a portfolio was invested as 60% stock/40% bonds twenty years ago and never rebalanced, you would end up today with a 70% stock/30% bonds allocation.

Not only are you exposed to more volatility than you originally anticipated, but almost certainly you lost out on some additional return by not selling outperforming asset classes to purchase lagging ones. In this example, by not rebalancing at least annually at year-end, your portfolio would have returned on average 0.4% annually less than its rebalanced counterpart.

Portfolio diversification is an ongoing process in a constantly evolving market and changes in your financial goals. Your portfolio needs to be periodically revisited to ensure that it is still meeting your objectives and risk tolerances. Additionally, location of these assets within various types of accounts plays a role in diversification as well. Working with a trusted investment advisor is a way to assess your specific needs and risks within your portfolio.

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[1] Morningstar Analytics. Investment is represented by the Ibbotson® Large Company Stock Index from 1997-2016. An investment cannot be made directly in an index. Data assumes reinvestment of income and does not account for taxes or transaction costs.

Andy Bruns is a portfolio analyst with John D. Dovich & Associates, LLC. Andy graduated cum laude from Xavier University in 2008 with a BSBA and a double major in Finance and Accounting. He received his CFA charter in 2015.

As a portfolio analyst, Andy provides research on investments and analysis for financial planning, working with a team of financial advisors within our firm. Andy's professional experience before joining John D. Dovich & Associates, LLC includes various financial roles at both Opus Capital Management and Wells Fargo Financial.

Definitions:

The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Barclays US Agg Bond is an index used by bond funds as a benchmark to measure their relative performance. The index includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.