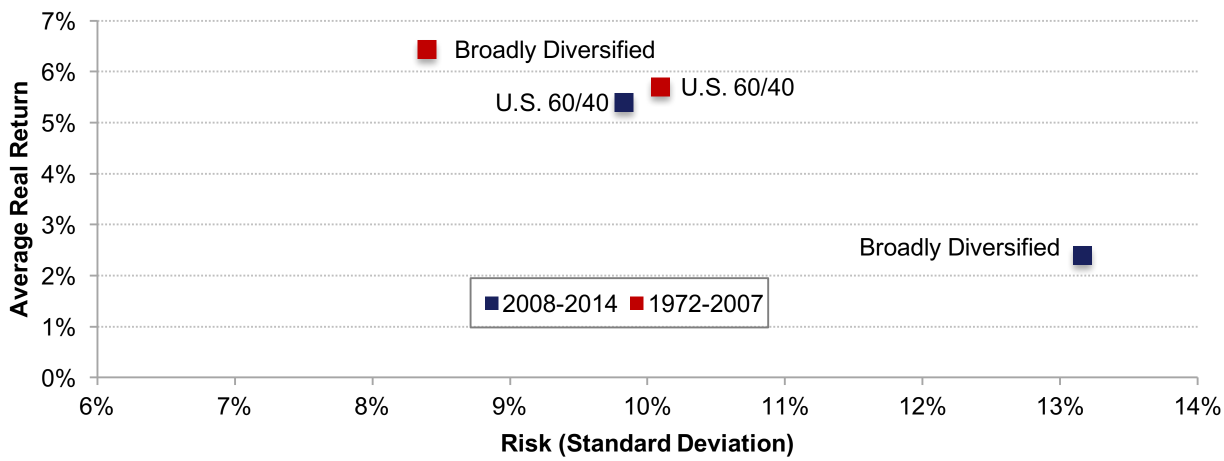
Asset Class Diversification: This Time Was Different, Again

February 17, 2015

Some two years ago, in a white paper titled "Asset Class Diversification: This Time Was Different," we wrote about the notably poor performance of diversified portfolios since the financial crisis relative to a simple portfolio of U.S. stocks and bonds. Prior to 2008, investors were rewarded with higher returns as well as lower volatility by broadening into asset categories such as foreign equities, foreign bonds, real estate, and commodity-related areas. Since then, however, diversification away from U.S.-centric portfolios has not been a winning strategy; a finding that was even more pronounced in 2013-2014.

An update of the analysis is summarized in **Exhibit 1**. The comparison portfolios are U.S. 60/40 and a more broadly diversified portfolio comprised of U.S. equities (20%), non-U.S. developed equities (20%), emerging markets equities (10%), U.S. REITs (10%), commodities (10%), and U.S. bonds (30%). Returns are shown after inflation (CPI index), and standard deviations are based on monthly data.

Exhibit 1: U.S.-Centric Portfolios Outperformed Broad Asset Class Diversification After 2007*



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The data show how diversification succeeded in the period from 1972 to 2007 by reducing volatility even while increasing return. But since 2007, the diversified portfolio has delivered less than half of its prior real return with 60% greater volatility. The U.S. 60/40 portfolio by contrast had a similar real return and volatility in both periods.

The return part of this story is not complicated: after 2007, U.S. equities and bonds both performed extraordinarily well relative to the other markets. Over the seven years from January 2008 to December 2014, U.S. equities returned 7.5% p.a. while non-U.S. developed equities were flat and emerging equities were slightly down. U.S. bonds also did well as interest rates declined, returning 4.8% p.a. over the period. Long stretches of outperformance like this have occurred before, but they are not confined to U.S. markets and can end with meaningful reversals. For example, U.S. equities significantly outperformed foreign equities in the years leading up to the market bubble that peaked in mid-2000, but it then took six years for them to return to that peak value. Over that same six-year period, while U.S. equities returned zero percent, non-U.S developed equities returned 5.1% p.a., emerging equities returned 15.6% p.a., commodities returned 9.2% p.a., and REITs returned 20.0% p.a.

With regards to the volatility gap, the explanation is that U.S. 60/40 benefited after 2007 from a negative correlation between equities and bonds—the tendency of one to cushion the other's declines and dampen portfolio volatility. The "diversifying" asset classes, on the other hand, were uncharacteristically highly correlated for much of the period, and they were also more volatile, the combination of which exacerbated the range of movements in a more broadly spread portfolio. We view the post-2007 period as a significant outlier on this dimension, however, and correlations among the broad asset classes have already diminished significantly.

The extraordinary seven-year performance of U.S. 60/40 relative to the rest of the world has happened before but it is not the norm when viewed in the context of a longer history, nor must it necessarily end benignly. In this period, as the disparity in performance has grown, so too have the valuation discrepancies between U.S. and foreign equity markets. On a cyclically adjusted basis, the price-earnings multiple of U.S. equities is now at a 30% premium to non-U.S. developed equities, and almost double that of emerging equities. What seems "safe" is expensive and what seems "risky" is a lot cheaper. By the risk and valuation metrics we track, diversification matters and outsized exposure to U.S.-centric investments is something we would be cautious about today.

Vanilla Portfolios: The Need for Return Enhancement

As we look ahead, generating returns from asset allocation and active management will be especially important. The reason is simply that we are in a market environment in which vanilla equity/bond portfolios by themselves are not as likely to deliver on customary levels of return.
With respect to bonds, future returns mathematically have to be low given paltry yields, at least on a hold-to-maturity basis. In the United States, ten-year bonds are currently yielding 2.0% p.a. while in Germany and Japan, they yield less than 0.4% p.a. Two year bonds in Japan are yielding zero, while in Germany they are negative, at -0.2% p.a. (Yes, the world is actually paying for the privilege of lending money to Germany.)

Equities are difficult to handicap, as they always are, because future outcomes will be dictated primarily by what is not already reflected in current prices. Nevertheless, if history is a guide and equity returns exceed those of bonds by their average over the last century, we should expect global equities from here to return around 6-7% p.a. given current interest rates. An outcome in this range would be slightly better than the performance of global equities over the last decade; it would also be consistent with current market valuations.

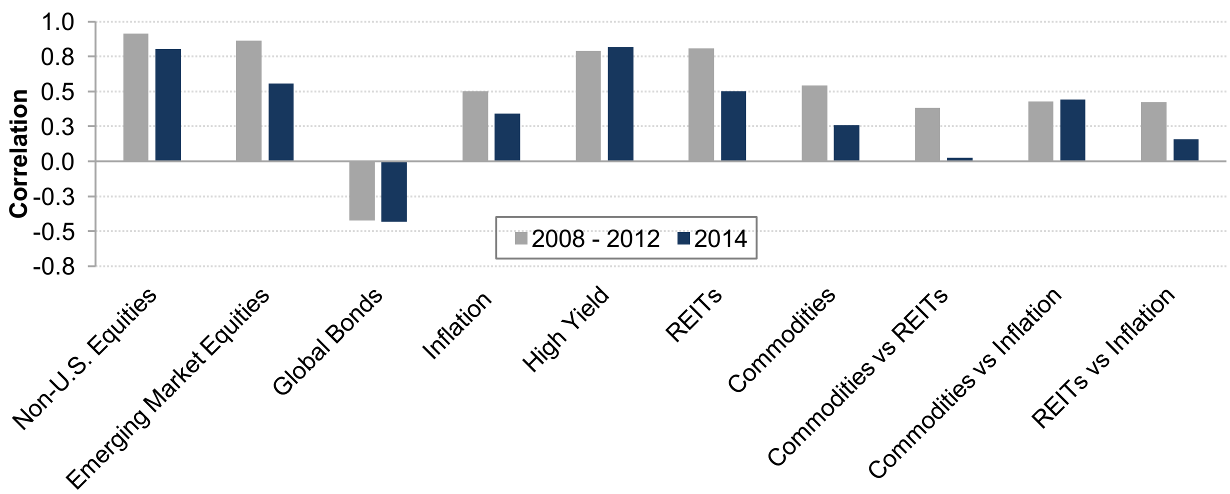
The resulting implication is that a 60/40 equities/bonds portfolio should reasonably be expected to return 4-5% p.a. or around 3% p.a. after inflation. These return levels are about 1.5% p.a. lower than achieved by 60/40 over the last decade, a period when declining interest rates provided a significant tail wind for portfolios with large fixed income components.

Improving on these prospects comes down to investing beyond vanilla exposures across a broader variety of return sources—a way to better protect capital and to achieve higher returns. As already mentioned, given that markets today are moving in a less interdependent fashion, we believe that today's environment is better suited to doing so than in the recent past.

At the asset class level, the changing pattern of market co-movements is shown in Exhibit 2. Most notably, emerging market equities, REITs, and commodities are much less correlated with U.S. equities than in the recent past, while bonds continue to cushion equity downdrafts. Commodities and REITs, moreover, seem to have very little correlation with one another. It's an environment that facilitates holding higher average exposures than would be possible in a concentrated portfolio with the same risk.

Exhibit 2: Asset Class Correlations Are Much More Attractive*

(Correlations with U.S. Equities Unless Otherwise Indicated, Weekly Returns)



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We stress that asset class diversification is not an end unto itself, but a means to help optimize return for a specific amount of risk. To do this well requires that we track the dynamic nature of markets and continuously revisit the risk-return trade-off. The same thinking applies to our active investments where we also seek to produce returns that are less correlated with traditional markets. These are essential ingredients of portfolio management, and all the more critical in the current environment.

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Definitions for Exhibit 1 are as follows:

Asset Class	Index
Broadly Diversified	U.S. Equities (20%): S&P 500 Non-U.S. Developed Equities (20%): MSCI Daily TR Net EAFE USD Index Emerging Markets Equities (10%): MSCI Daily TR Net Emerging Markets USD Index U.S. REITs (10%): FTSE NAREIT All Equity Total Return Index Commodities (10%): S&P GSCI Reduced Energy Official Close TR Index U.S. Bonds (10%): Barclays US Agg Long Treasury Total Return Index (12/31/1971-12/31/1975); Merrill Lynch 7-10yr Index (12/31/1975-
U.S. 60/40	Represents a portfolio with 60% invested in the S&P 500 and 40% invested in the Merrill Lynch 5-7 Year U.S. Treasury Index

Definitions for Exhibit 2 are as follows:

Asset Class	Index
U.S. Equities	Russell 3000 Index
Non-U.S. Equities	MSCI EAFE Index*
Emerging Equities	MSCI Emerging Markets Index*
U.S. Bonds	Merrill Lynch 7-10yr U.S. Treasury Index
Non-U.S. Bonds	JP Morgan Global Government Bond Ex-US Hedged USD Index
High-Yield Bonds	Merrill Lynch High Yield Bond Master II Index*
Emerging Bonds	JP Morgan EMBI+ Emerging Market Bond Index
U.S. TIPS	Barclays U.S. Inflation Protected Securities Index
Non-U.S. Inflation Protected Bonds	Barclays World Govt. Ex US Inflation-Linked Bonds Hedged USD Index
REITs	NAREIT Real Estate Investment Trust Index
Commodities	S&P GSCI Reduced Energy Total Return Index