Is Diversification Dead?

It's a fair question, because 2018 saw the vast majority of assets fall in value and, so far, 2019 has seen the vast majority of assets rise.

To clarify this a little further, Deutsche Bank analyse a broad range of assets and in their sample (excluding currencies), 31 of the 38 assets made losses in local currency terms in 2018, whilst in the first half of 2019, 37 of the 38 assets made gains (Silver was the only loser).

What's been going on?

From a very top-down perspective, over the longer term, asset classes are sensitive to economic growth and/or inflation.

Last year saw assets struggle due to weakening economic growth (including the impact of the US/China trade war) and interest rate hikes, this year has seen assets benefit from more dovish central banks - And interest rates were the common theme.

In short, tighter monetary policy hurt last year and an 'about turn' by banks at the beginning of this year led to assets rallying.

So, where to from here?

Without any doubt, at this time uncertainty around those key drivers of economic growth and interest rates has increased, with a corresponding amount of uncertainty around the movement of asset classes in their 'traditional' patterns - so is it time for a different strategy?

Quite clearly the answer is no – And here's why…

For years and years, financial advisers have preached the wisdom of a diversified portfolio, weighted between stocks, bonds and other assets according to an individual's age and appetite to risk.

But after experiencing the 2008-2009 financial crisis, when nearly all financial markets fell in unison, some investors question that notion – And indeed they are questioning it again now after the recent events mentioned above

Let's justify this by taking a quick look at how diversification works

Under normal market conditions, diversification is an effective way to reduce risk.

If you hold just one investment and it performs badly, you could lose all of your money.

If you hold a diversified portfolio with a variety of different investments, it's much less likely that all of your investments will perform badly at the same time.

The profits you earn on the investments that perform well offset the losses on those that perform poorly.

For example, bonds and stocks often move in opposite directions. When investors expect the economy to weaken and corporate profits to drop, stock prices will likely fall. When this happens, central banks may cut interest rates to reduce borrowing costs and stimulate spending. This causes bond prices to rise.

If your portfolio includes both stocks and bonds, the increase in the value of bonds may help offset the decrease in the value of stocks. The reason for including bonds in a portfolio is not to increase returns but to reduce risk.

In theory, diversification enables you to reduce the risk of your portfolio without sacrificing potential returns. An efficient portfolio has the least possible risk for a given return. Once your portfolio has been fully diversified, you have to take on additional risk to earn a higher potential return on your portfolio.

But I know what you are going to say next: “Occasionally we are not working under ‘normal market conditions’ … What should I do then?”

You should do absolutely nothing different, because the key word there is ‘occasionally’ and history tells us they are rare events that only last for a short period of time – Normality nearly always resumes quite quickly, so you just have to hold your nerve – However difficult that may be at such times.

(And if you needed more evidence!), here are 4 reasons to always diversify your portfolio:

Not all types of investments perform well at the same time.

Normally, different types of investments are affected differently by world events and changes in economic factors such as interest rates, exchange rates and inflation rates.

Diversification enables you to build a portfolio whose risk is smaller than the combined risks of the individual securities.

If your portfolio is not diversified, it will be unnecessarily risky. You will not earn a higher average return for accepting the unnecessary risk.

To Conclude …

Each specific investment has specific risks, so to diversify keeps the risk balanced and lower.

For example, if you invest in a Canadian car company that buys unique parts from a manufacturer in the Eurozone and the price of the Euro goes up in relation to the Canadian dollar, the company’s costs will rise and profits will fall.

In this case, share prices may drop too. Other specific investments won’t be subject to the same risk at the same time.

You reduce your overall risk by diversifying your portfolio.

Similarly, you can diversify the bond portion of your portfolio by including a mix of bonds with different credit ratings and durations. This is effective because the values of bonds with strong credit ratings and those of bonds with weak credit ratings respond differently to changes in the economy. Similarly, bond values respond differently to changes in interest rates depending on their duration.

A well-diversified portfolio provides reasonable protection under normal market conditions and diversification works because, in general, asset prices do not move perfectly together.

However, diversification becomes less effective in extreme market conditions – And typically, conditions ONLY become extreme when something unexpected occurs.

Examples are a market crash, government default or a significant world event like 9/11.

But these are the minority of times, and even during these times a diversified portfolio will also limit any losses to less than those investors who are holding an unbalanced portfolio – So in the end it is always better to diversify in both good time and bad.