Voya Global Perspectives

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Executive Summary

- Diversification works in the long run in terms of both risk and return
- An overconcentration in the S&P 500 is putting all your eggs in one basket
- It's always a good time to own bonds
- In 2016 the diversification tortoise is beating the S&P 500 hare

The Diversification Tortoise Takes the Lead Once Again

We have seen this movie before — the bull market concentrates its attention on the most popular benchmark, the S&P 500. To paraphrase an old adage, "A financial advisor never got fired for buying the S&P 500." But can too much of a good thing be a bad thing?

Certainly, concentrating a portfolio in the most recognizable equity index in the world has worked well for the past five years, beating all comers — well, at least most. Remember the market from 1993 to 1999 when the S&P 500 surged into the final year of that run? The story ended swiftly with the bursting tech bubble. For the next 11 years, the venerable S&P 500 was consistently beaten by the globally diversified portfolio, with a whole lot less risk.

Demystifying Diversification

Diversification works over time by exposing the portfolio to high-potential-return, volatile asset classes that, when combined, actually reduce risk and increase return. It does this with straightforward mathematics, integrating return, standard deviation and correlation. It's also intuitive, as simple as the old saying "don't put all of your eggs in one basket." Investing in multiple "baskets," or a broad range of asset classes such as stocks and bonds, increases the probability of stable performance: some of your baskets may go up even as others are going down. The net result of splitting your eggs into multiple baskets is intuitively lower risk but there is also a higher probability that the investor will tend to outperform a single concentrated basket that may be the biggest loser.

We don't know the future but the past is known with certainty and can be examined in a variety of good, bad and ugly market environments. Consider a rejoinder from Mark Twain that "history doesn't repeat itself but it often rhymes" and take a look at the past two decades of market history.

Is History about to Rhyme?

Global diversification vs. S&P 500 returns, calendar years 1996 through 2015 and YTD 8/31/16

Return Periods	Global Diversification (%)[1]	S&P 500 (%)	Outcome
Five Years			
1996–2000	9.2	18.3	S&P outperforms
2001–2005	9.7	0.5	Diversified outperforms
2006–2010	7.6	2.3	Diversified outperforms
2011–2015	6.6	12.6	S&P outperforms
YTD 2016	11.2	7.8	Diversified outperforms
20 Years			
Return	8.3	8.2	Diversified outperforms
Standard deviation	11.9	18.8	Diversified has lower risk

Sources: FactSet, Voya Investment Management. Five- and twenty-year return periods are annualized.
[1] Note: "Global AA" includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI EM Index, Barclays U.S. Corporate Bonds, Barclays U.S. Treasury Bonds, Barclays Global Aggregate Bonds, Barclays U.S. High Yield Bonds. For illustration only. **Past performance is not a guarantee of future results. Investors cannot invest directly in an index.**

In the five-year period from January 1996 through December 2000, the S&P 500 dominated a basket of globally diversified equity and fixed income investments. The fact that equities beat this portfolio which included low risk assets is not hard to understand. Investors did well with the portfolio during this time, on average 9.2%, but not nearly as well as being in the S&P 500, which returned on average 18.3%. At the time, there was a plethora of articles and media mavens poking fun at the folly of diversification. Then it happened. Just when a preponderance of investors threw in the towel against the disparaged notion of diversification; the theory worked its magic in practice. For the next ten years from 2001–2010 the diversified portfolio crushed the S&P 500 and — to add insult to injury — with a lot less risk!

Fast forward to 2016. Once again, the S&P 500 has been the dominant asset class for the past five calendar years. But this year, the diversified portfolio is handily beating the S&P 500. In fact, the S&P 500 is the second worst asset class — even underperforming bonds. Is history about to rhyme? Following a five-year run and while at an all-time record high, the S&P 500 is looking tired compared to its downright perky competitors.

While the S&P 500 is undoubtedly an important part of a diversified portfolio, it is not the only important part. It is unusual for one asset class to be so dominant for an extended period, especially the most widely followed and fully priced index in the world. Will this pattern continue? We don't know, but we certainly don't recommend that investors put all their eggs in one basket.

Diversification in a Low Yield-Low Growth World

Most investors say they are diversified but a closer look often shows that they are actually "gaming" diversification, a poor substitute for an effectively diversified portfolio. A good example this year was the "unorthodox" notion of investing in long maturity bonds when the U.S. Federal Reserve was expected to raise rates aggressively. Investors, mistaking this forecast for certainty, took "rational" action and moved their fixed income positions to the shortest maturity (duration) bonds they could find. This forecast turned out to be vastly incorrect. The long duration bonds that were dumped performed extraordinarily well, while the short duration bonds performed horribly. By trying to outrun interest rate risk, investors herded into positions that increased it instead, and incurred losses. Such behavior implies a misunderstanding of the central role of bond investments: bonds certainly can be used for income, but their most important feature is lowering the volatility or risk of a portfolio. Losing sight of this principle and misusing bonds can lead to higher risk and higher volatility.

When building a portfolio the questions have never been, nor should ever be, "Where are yields going?" or "When is the Fed going to raise rates?" The appropriate question is "What bonds should I choose that will most effectively hedge the equities in my portfolio if they experience severe negative returns?" The answer is the longer the bond maturity, the better to hedge against negative equity returns. In our view, the best risk control assets ever invented, better than any hedge fund, are 20-year plus U.S. Treasury bonds. During the Great Financial Crisis in 2008, when asset correlations purportedly went to one — i.e., when most asset classes moved in the same

Broad Global Diversification's Wide Net Captures Returns and Reduces Risk

Index	August 2016	YTD 2016	3 years	5 years	10 years	15 years
Equity						
S&P 500	0.1	7.8	12.3	14.7	7.5	6.5
S&P MidCap 400	0.5	13.1	11.5	14.1	9.3	9.5
S&P SmallCap 600	1.4	13.2	11.0	15.2	8.7	9.7
Global REITs	-2.6	12.0	11.0	10.4	4.5	9.9
EAFE	0.1	0.9	2.9	5.5	2.2	5.4
Emerging Markets	2.5	14.8	1.5	-0.1	4.2	10.6
Average	0.3	10.3	8.4	10.0	6.1	8.6
Fixed Income						
Corporate	0.2	9.5	6.0	5.2	6.1	5.9
U.S. Treasury 20+	-0.9	17.5	12.6	8.5	8.6	7.9
Global Aggregate	-0.5	9.2	2.6	1.1	4.2	5.1
High Yield	2.1	14.3	5.4	7.5	7.8	8.1
Average	0.2	12.6	6.7	5.6	6.7	6.7
Overall Average	**0.3**	**11.2**	**7.7**	**8.2**	**6.3**	**7.9**

No Lost Decade

Data as of 08/31/2016
Sources: FactSet, FTSE NAREIT, Voya Investment Management

Long U.S. Treasury Bonds Have Played an Important Role in Diversifying Portfolios

Global asset allocation returns, 2005–2015

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Emerging Mkts 44.5	Emerging Mkts 56.6	Emerging Mkts 59.1	U.S. Treas 20+ 33.7	Emerging Mkts 93.5	Mid Cap 26.6	U.S. Treas 20+ 33.8	Global REITs 29.8	Small Cap 41.3	U.S. Treas 20+ 27.5	S&P 500 1.4
MSCI EAFE 14.0	Global REITs 43.7	MSCI EAFE 11.6	Global Bonds 4.8	High Yield 58.2	Small Cap 26.3	Corp Bonds 8.1	MSCI EAFE 17.9	Mid Cap 33.5	Global REITS 15.9	Global REITs 0.1
Mid Cap 12.6	MSCI EAFE 26.9	Global AA 10.5	Corp Bonds -4.9	Global REITs 41.3	Global REITs 20.0	Global Bonds 5.6	Mid Cap 17.9	S&P 500 32.4	S&P 500 13.7	MSCI EAFE -0.4
Global AA 10.0	Global AA 19.2	U.S. Treas 20+ 10.2	Global AA -24.8	Mid Cap 37.4	High Yield 15.1	High Yield 5.0	Small Cap 16.3	MSCI EAFE 23.3	Mid Cap 9.8	Corp Bonds -0.7
U.S. Treas 20+ 8.6	S&P 500 15.8	Global Bonds 9.5	High Yield -26.2	MSCI EAFE 32.5	S&P 500 15.1	S&P 500 2.1	S&P 500 16.0	Global AA 11.9	Global AA 7.7	U.S. Treas 20+ -1.6
Global REITs 8.3	Small Cap 15.1	Mid Cap 8.0	Small Cap -31.1	Global AA 31.9	Global AA 14.5	Global AA 1.1	High Yield 15.8	High Yield 7.4	Corp Bonds 7.5	Global AA -1.8
Small Cap 7.7	High Yield 11.8	S&P 500 5.5	Mid Cap -36.2	S&P 500 26.5	Emerging Mkts 9.8	Small Cap 1.0	Emerging Mkts 14.9	Global REITs 2.2	Small Cap 5.8	Small Cap -2.0
S&P 500 4.9	Mid Cap 10.3	Corp Bonds 4.6	S&P 500 -37.0	Small Cap 25.6	U.S. Treas 20+ 9.4	Mid Cap -1.7	Global AA 14.6	Corp Bonds -1.5	High Yield 2.5	Mid Cap -2.2
High Yield 2.7	Global Bonds 6.6	High Yield 1.9	MSCI EAFE -43.1	Corp Bonds 18.7	Corp Bonds 9.0	Global REITs -8.1	Corp Bonds 9.8	Global Bonds -2.6	Global Bonds 0.6	Global Bond -3.2
Corp Bonds 1.7	Corp Bonds 4.3	Small Cap -0.3	Global REITs -48.9	Global Bonds 6.9	MSCI EAFE 8.2	MSCI EAFE -11.7	Global Bonds 4.3	Emerging Mkts -3.3	Emerging Mkts -1.8	High Yield -4.5
Global Bonds -4.5	U.S. Treas 20+ 0.9	Global REITs -4.7	Emerging Mkts -59.3	U.S. Treas 20+ -21.4	Global Bonds 5.5	Emerging Mkts -22.7	U.S. Treas 20+ 3.4	U.S. Treas 20+ -13.9	MSCI EAFE -4.5	Emerging Mkts -14.6

Note: "Global AA" includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI EM Index, Barclays U.S. Corporate Bonds, Barclays U.S. Treasury Bonds, Barclays Global Aggregate Bonds, Barclays U.S. High Yield Bonds. For illustration only. **Past performance is not a guarantee of future results. Investors cannot invest directly in an index.** Sources: FactSet, Voya Investment Management

direction at the same time — long-maturity, U.S. Treasury bonds returned +33.8% for a nearly perfect negative correlation!

Once the bonds are appropriately positioned, how does an investor build the equity portion of the portfolio — especially in a low growth-low yield world? Well, now it gets tricky. We believe the prudent approach is to buy a range of equities with higher growth prospects and lower correlation to the S&P 500. Are these riskier? Yes, but the math of it, called "modern portfolio theory," is that by adding riskier asset classes to a well-diversified portfolio actually causes risk to go down and return to go up.

Do you mean buy emerging markets? Yes. Do you mean buy risky U.S. small-cap stocks? Yes. Do you mean trimming my holdings of high dividend paying, large cap stocks to buy equities with lower yield, higher future earnings growth that may be riskier? Yes.

This last one may be the most disputed but is the most critical.

By demanding high dividends, current income investors actually are decreasing future income that might come from potential earnings growth. In the equity portion of the portfolio, we believe it is earnings that should be bid up, not dividends. Earnings are future dividends. In other words, patient capital is rewarded. Demand for high liquidity and current income reduces future returns. A portfolio certainly needs income and liquidity but that is what the bonds are for. Blurring the roles between asset classes may be investors' biggest mistake of all.

In 2016 this counterintuitive approach based on modern portfolio theory begins to make sense. Fixed income, in particular the longer maturity bonds that investors feared, has done its job lowering risk and even increasing return of the overall portfolio by outperforming equities. The riskier equity asset classes led by emerging markets, U.S. small-caps and U.S. midcaps have been bolstering the lower return S&P 500, which is actually the second to worst asset class this year across a broadly diversified portfolio. The net result of this is that the diversified portfolio has both lower risk and double digit returns compared to the higher risk S&P 500 with single digit returns.

Conclusion

Building an effective portfolio is not easy. Pervasive low-yield, low-growth conditions compound the difficulty of this endeavor and demand a savvy, more rigorous approach that utilizes a broad range of investments from around the world. Building a portfolio that is grounded with ballasts from a range of bonds allows an investor to add equities with higher return, albeit with higher risk but with the benefit of lower correlation. In our view, though diversification is periodically in disrepute, as in Aesop's fable the tortoise wins the race.

Diversification does not guarantee a profit or ensure against loss

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