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Effective Diversification: The 2014 Edition

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As one year turns into the next many people find themselves contemplating what they could have done better in their personal lives. They should treat their investing lives with no less circumspection, considering whether their portfolios were effectively diversified to build wealth within their individual "normal" risk tolerance. "Normal" is key here, as many investors have been too risk averse, too defensive and practically balled up in a fetal position since the 2008 Credit Crisis. Welcome to 2014!

The effectively diversified portfolio is neither the highest-return portfolio nor the lowest-risk portfolio, which are identifiable only in hindsight. The effectively diversified portfolio is the one that takes prospective positions across a range of returns, risks and correlations. It is based on sound financial theory and empirical evidence and is perhaps best captured by the cliché "don't put all your eggs in one basket". But investors have a bad habit of trying to mess around with diversification, herding into the best-performing asset classes and fleeing the worst — after the fact — in a fashion we coined the "folly of gaming diversification".

What was clear in 2013 is that it paid to be in the market. Before looking at strategies for 2014, let's briefly review the recently completed calendar year.

2013: Best Year Since 1997 for U.S. Equities

While the U.S. market was dominant in 2013, broad global equity diversification contributed to positive investment returns, while being slightly offset by modestly negative bond returns on average.

As we wrap up the fifth year of the current bull market, U.S. equities hit record levels across the board. Small caps led the pack with 41% total return, but mid and large caps returned 33% and 32%, respectively. Mid-cap stocks continue to outperform large caps on a long-term basis, as they offer the appealing combination of the wherewithal of a large company and the growth potential of a small one. While the Federal Reserve's extraordinary monetary stimulus certainly acted as a support to domestic markets, gains were further driven by fundamental strength in corporate profits, consumer spending, housing, manufacturing and other positive economic factors that ultimately led the central bank to begin tapering its bond buying.

Developed areas of Europe, Australasia and the Far East had banner years of their own, as the MSCI EAFE Index was up more than 23% in 2013. In Europe, signs of economic recovery and accommodative central bank policy helped drive equities higher, while markets also cheered stronger economic growth in China and the U.S. Japan made a

Executive Summary

- **While the U.S. market was dominant in 2013, broad global equity diversification contributed to positive investment returns.**
- **Surging equity markets were an example of "upside risk" that hit some investors hard in 2013.**
- **Effective diversification should be meaningfully global within equity and fixed income, distributed broadly across asset classes and rebalanced on a periodic basis.**
- **If you invest like everyone else, you likely will experience the same subpar returns that everyone else does.**

Developed Market Equities Finish Strong Year on Strong Note

Index	Dec-13	QTD	2013	1 Year	3 Years	5 Years	10 Years	15 Years
Equity								
S&P 500	2.5	10.5	32.4	32.4	16.2	17.9	7.4	4.7
S&P MidCap 400	3.1	8.3	33.5	33.5	15.6	21.9	10.4	10.0
S&P SmallCap 600	1.4	9.8	41.3	41.3	18.4	21.4	10.7	10.3
Global REITs	(0.3)	(1.1)	2.2	2.2	6.8	15.6	7.5	9.6
EAFE	1.5	5.7	23.3	23.3	8.7	13.0	7.4	5.0
Emerging Markets	(2.1)	1.7	(3.3)	(3.3)	(4.9)	12.8	12.1	13.3
Average	1.0	5.8	21.6	21.6	10.1	17.1	9.2	8.8
Fixed Income								
Corporate	(0.2)	1.1	(1.5)	(1.5)	5.4	8.6	5.3	5.9
U.S. Treasury 20+	(2.0)	(3.2)	(13.9)	(13.9)	6.0	0.5	6.1	6.1
Global Aggregate	(0.6)	(0.4)	(2.6)	(2.6)	2.4	3.9	4.5	4.8
High Yield	0.5	3.6	7.4	7.4	9.3	18.9	8.6	7.5
Average	(0.5)	0.3	(2.6)	(2.6)	5.8	8.0	6.1	6.1
Overall Average	**0.4**	**3.6**	**11.9**	**10.8**	**8.8**	**14.1**	**8.7**	8.5

Source: FactSet, FTSE NAREIT, ING U.S. Investment Management

No "Lost Decade"

meaningful contribution to the index due to surprise monetary stimulus from the Bank of Japan, which ultimately increased growth, kick-started inflation and sent local markets surging more than 50% for the year.

In contrast, emerging markets underperformed for yet another year, with the MSCI BRIC Index ending 2013 in slightly negative territory. Midyear tapering talk sunk the emerging markets, especially those with high current account deficits. The surprise delay of tapering in September extended a lifeline to many of these markets, however, and they delivered an early-autumn surge, though it was not enough to propel the index above breakeven.

With interest rates moving higher, REITs also had a tough year in 2013. Global REITs were the best-performing asset class in 2012, returning close to 30% as large-cap equities moved 16% higher. This would not be the first or last time that a year's hottest asset class attracted a disproportionate share of assets only to promptly cool in the year that followed. But REITs are not as interest sensitive as many think, and commercial real estate earnings should improve with the economy in 2014.

Fixed income was another story in 2013, with most asset classes posting losses as interest rates ticked higher. Long U.S. Treasuries, in particular, bore the brunt of an improving economy that is commensurate with rising rates, Fed tapering and diminished global risk, posting losses of 13.9%. These conditions have triggered a rotation out of Treasuries, though the flow to equities is but a trickle; instead, cash is moving from perceived safe havens to credit-driven fixed income investments like high yield bonds, which returned 7.4%.

Global bonds were severely impacted by the tapering talk and have not fully recovered, ending the year down 2.6%. However, the knee-jerk spike in yields should be more muted going forward as the Fed tapers in a measured and deliberate fashion. Overall, there are plenty of global opportunities offering higher yields than in the U.S. with the additional benefits of currency exposure and diversification.

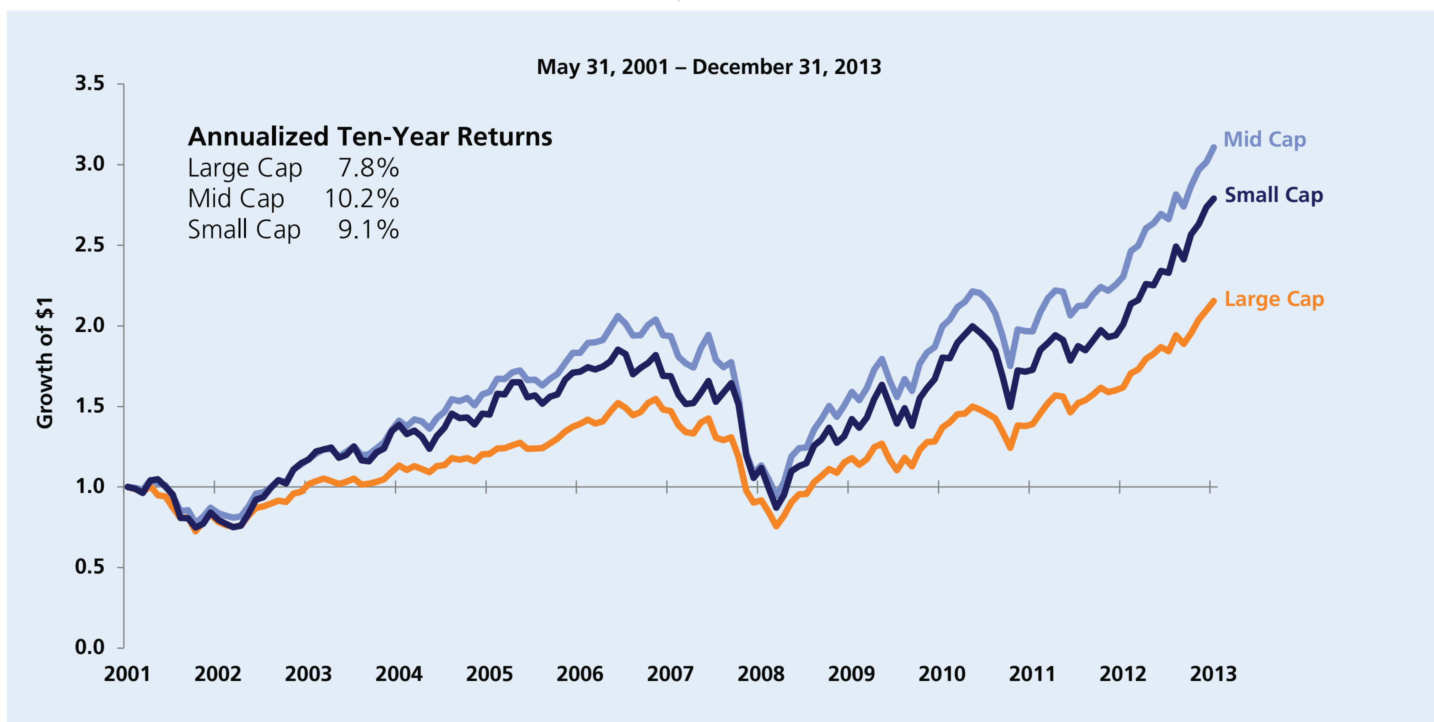
2014: It's Never Too Late to Invest Effectively

In light of the pronounced stock market rally, many sidelined investors are wondering: "Is it too late to get back into equities?" But that's the wrong question to ask when attempting to build effective portfolios; instead, investors should be asking: "What are the catalysts for growth that will continue to drive the market?" These four drivers, which we discussed at length in our 2014 forecast,[1] are the "tectonic shifts" in the real economy that tend to show up in consumer and manufacturing statistics first before being recognized in corporate earnings growth.

While our tectonic shifts remain the fundamental market catalysts, this year may also see a technical catalyst in the form of money flows. Investors have been so preoccupied staring into the abyss of downside risk that they suffered from not being in a market that was in a "melt-up". You see, risk is not only what is widely reported in the media; more damaging is the risk that comes seemingly out of nowhere

[1] "Broadening Global Economic Expansion", *ING Global Perspectives 2014 Forecast*, December 2013.

Mid-Cap Stocks Have Outperformed Other U.S. Equity Classes over the Past Ten Years



Note: Growth of $1 and annualized ten-year returns are based on the Russell 1000 Index for large cap, the Russell Midcap Index for mid cap and the Russell 2000 Index for small cap.

Source: FactSet, Russell Investments

and hits you in the back of the head. Surging equity markets — especially of this magnitude — are the definition of an "upside risk" that hit investors hard in 2013.

The opportunities in 2014 may include both those asset classes that have clear momentum as well as the beat-up, unloved and downright cheap investments that currently may be providing an opportune entry point. We believe that effective diversification should be meaningfully global within equity and fixed income, distributed broadly across asset classes and rebalanced on a periodic basis. To briefly explore these principles:

- **Global equity diversification.** Global diversification boosts both minimum and expected returns, mitigates U.S.-only risks and helps control overall volatility. The U.S. accounts for only about 40% of the world's equity market capitalization, which means U.S. investors limiting themselves to domestic markets are neglecting about 60% of existing opportunities. Investing globally means expanded horizons and a richer set of investment opportunities.
- **Global fixed income diversification.** Bonds, meanwhile, have been among the best asset classes for risk control. Similar to U.S. equities, U.S. bonds account only for about 50% of the world's outstanding fixed income obligations. Many commentators are warning investors off bonds these days given the potential for rising interest rates. Those that do so, however, miss the point of fixed income exposure: namely, risk control and downside protection in uncertain environments. Furthermore, investors can shed some interest-rate risk by extending to credit, currency, global bond, emerging debt and high yield.
- **Equal-weighted portfolio construction.** In our view, market-cap weighting is the Achilles' heel of index construction and a source of unreliable returns. No matter how you slice and dice equity indexes — by market cap, style, sector or individual issues — equal weighting, as opposed to market-cap weighting, adds value over reasonably long time frames. Market-cap weighting is a bet on price momentum, and a big one at that. It is finally an acknowledgement that forecasting the performance of asset classes with vastly different characteristics is folly; if it is important enough to own, it should then be owned at full weight equally.
- **Rebalancing.** This institutionalizes the proper investment discipline of "buy low and sell high". Annually is a great time to rebalance a portfolio, but it can also be done more frequently. The point is to regularly trim the winners and buy the losers. Entering 2014 with U.S. Treasuries yielding around 3%, an appropriate rebalance would involve trimming U.S. equity exposure and buying emerging market stocks, which are trading at a discount of about 30% to the U.S. in terms of P/E ratio.

The U.S., Europe and Japan Led the Way in 2013, While Emerging Markets Lagged

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Pac Ex-Japan -5.8%	EME 56.3%	Pac Ex-Japan 29.6%	EME 34.5%	Europe Ex-UK 36.4%	EME 39.8%	Japan -29.1%	EME 79.0%	EME 19.2%	S&P 500 2.1%	Pac Ex-Japan 21.7%	S&P 500 32.4%
EME -6.0%	Pac Ex-Japan 47.0%	EME 26.0%	Japan 25.6%	Pac Ex-Japan 33.2%	Pac Ex-Japan 31.7%	S&P 500 -37.0%	Pac Ex-Japan 73.0%	Pac Ex-Japan 17.1%	UK -2.5%	Europe Ex-UK 18.7%	Europe Ex-UK 28.7%
Japan -10.1%	Europe Ex-UK 43.6%	Europe Ex-UK 22.4%	Pac Ex-Japan 14.8%	EME 32.6%	Europe Ex-UK 17.5%	Europe Ex-UK -45.0%	UK 43.4%	Japan 15.6%	Pac Ex-Japan -12.7%	S&P 500 15.0%	Japan 27.3%
UK -15.2%	Japan 36.2%	UK 19.6%	Europe Ex-UK 11.3%	UK 30.7%	UK 8.4%	UK -48.3%	Europe Ex-UK 33.9%	S&P 500 15.1%	Japan -14.2%	EME 13.1%	UK 20.7%
Europe Ex-UK -19.9%	UK 32.1%	Japan 16.0%	UK 7.4%	S&P 500 15.8%	S&P 500 5.5%	EME -47.1%	S&P 500 26.5%	UK 8.8%	Europe Ex-UK -14.5%	UK 13.0%	Pac Ex-Japan 5.6%
S&P 500 -22.1%	S&P 500 28.7%	S&P 500 10.9%	S&P 500 4.9%	Japan 6.3%	Japan -4.1%	Pac Ex-Japan -50.0%	Japan 6.4%	Europe Ex-UK 2.4%	EME -18.2%	Japan 2.9%	EME -2.3%

Note: All data are based on equity indexes for each regional or country index and are total returns including dividends for each calendar year or partial year.

Source: MSCI, Standard & Poor's, FactSet

Following these principles for building effectively diversified portfolios has proven to be — well — fairly effective. Looking at the performance over the past ten years using a typical 60% equity/40% fixed income allocation, a few observations jump out:

- No "lost decade" here. A gross return over 8%, nearly one-third less risk than the market and a better return than either a U.S. large-cap equity- or fixed income-only allocation.
- The S&P 500, which is the most popular stock index, delivered performance that was among the worst equities had to offer. Meanwhile, the least-followed index, emerging markets, had the best performance by far, and U.S. mid- and small-cap indexes easily outpaced the S&P 500.
- Bonds had strong positive returns over the period and were up close to double digits for the past five years.

Conclusion

If all goes well, 2014 is set to be the sixth year of the current bull market. With an enormous amount of still-sidelined cash waiting to get back in, questions remain about how to deploy these funds effectively. Keep this in mind: If you invest like everyone else, you likely will experience the same subpar returns that everyone else does. If you invest effectively, you give yourself a better chance of enhancing total returns while managing downside risk. ■

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