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October Treat and the Folly of "Gaming Diversification"

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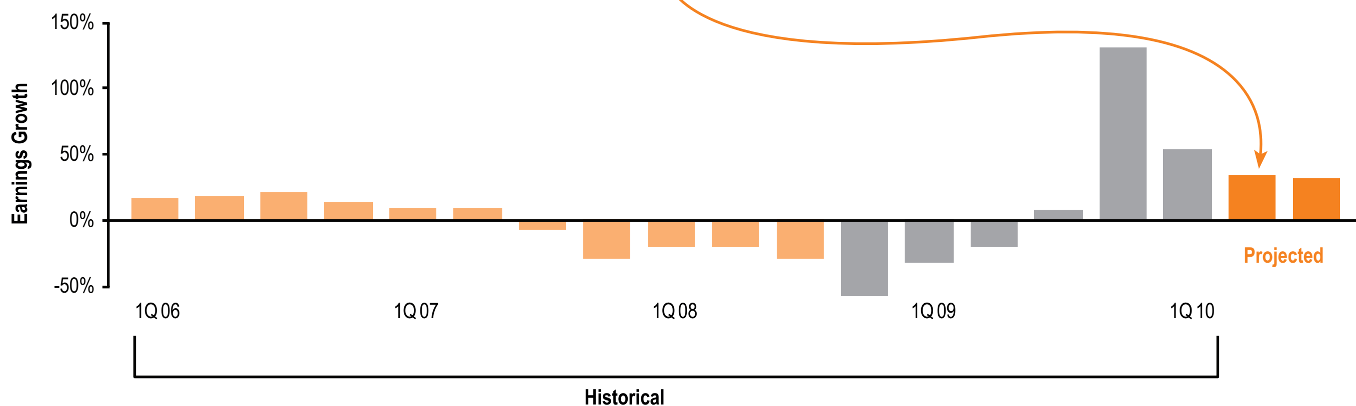
We pointed out last month that the September surprise in equity returns was a signal to get aboard the "express elevator" — that is, it's time for sidelined investors to get back into the equity markets. Despite an October that extended September's dramatic surge and swept year-to-date returns to near double digits, pessimism continues to abound. Driven by strong corporate earnings and expanding global demand, the turn in the market was swift and dramatic and left many investors who missed their chance at the rally hoping for a pullback to create an attractive entry point. Investors like buying cheap after the horse has left the barn. With or without a pullback, however, there is still a way to justify getting back into the market: diversification. Despite a brutal knock on its reputation as a result of 2008's difficult markets, diversification has been redeemed by what as of now looks like two consecutive years of strong double-digit returns in the equity markets. Diversification does work after all! The problem is that investors, by trying to outrun risk, are missing the benefit of recovering markets by not sticking to the discipline of diversification. This pernicious

With 70% of S&P 500 companies reporting, earnings show the 6th consecutive quarter of positive surprises, best in 20 years 3Q10 earnings review, S&P 500 historical and projected results

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual		Total	Percent	Positive	Negative	Percent	Positive	Negative
Consumer Discretionary	34	/	79	27.1%	30	4	11.3%	27	6
Consumer Staples	20	/	40	4.6%	14	6	0.2%	12	7
Energy	29	/	39	40.6%	21	6	0.2%	20	9
Financials	66	/	81	50.8%	46	18	19.2%	50	16
Health Care	41	/	51	9.9%	32	7	6.9%	36	5
Industrials	44	/	57	55.4%	39	5	5.2%	41	3
Information Technology	51	/	76	52.4%	43	6	9.0%	47	4
Materials	27	/	31	51.6%	23	4	5.1%	18	9
Telecommunication	3	/	9	-12.4%	1	2	0.1%	2	1
Utilities	28	/	34	14.3%	22	6	6.1%	18	9
S&P 500	**343**	**/**	**497**	**31.3%**	**271**	**64**	**7.5%**	**271**	**69**



Source: Bloomberg, Standard & Poor's

Note: Earnings Growth is the percentage change in the cumulative share weighted EPS Earnings from that of a year ago. Surprise Percent is the share weighted average of the ratio of actual company earnings vs. the consensus estimate.

trend in the financial industry is toward what I call “gaming diversification”.

Gaming diversification occurs when investors try to outsmart the markets by abandoning diversified positions in order to sidestep impending risks or to crowd into an area of strong returns. It tends to be reactionary in nature and directionally wrong. A recent example can be found at the end of 2009; given the consensus view that inflation was going to rear its ugly head, many investors tried to game the system by selling long-dated bonds in favor of short duration T-bills, a strategy that went horribly awry. Inflation went to zero, and the 20-year Treasury bond — yes, the same 20-year bond that is safely parked in the well-diversified portfolios of investors who did not try to game the market — has been one of the best performing asset classes in year-to-date 2010 with a total return of 15%. Investors were likewise complicit during the 1999 technology bubble as they “gamed” diversification by turning their portfolios into wholesale bets on technology with disastrous consequences.

Diversification (or portfolio theory) was first seriously explored as an investment concept by Harry Markowitz in the 1950s; he subsequently was awarded a Nobel Prize for this work integrating return, risk and correlation. William Sharpe simplified portfolio theory with the capital asset pricing model (CAPM) using beta, return of the market and the riskfree rate to calculate returns and risks for assets and portfolios. Money management was transformed over the next 50 years, as these fundamentals became part of conventional practice. However, the reliability of these theories was called into question during the 2000s as a result of two closely spaced bear markets, the most recent of which saw correlations among assets break down as global assets performed disastrously in 2008. It is no wonder diversification got a bad name.

In *The Black Swan*, Nassim Taleb declared that rare events happen with greater frequency in the financial markets than could be predicted by a normal distribution — one would think that investors would have learned this lesson by now. The distribution of returns in financial markets have always had “fat tails”, meaning that extreme events happen on a much more regular basis than normal distributions would suggest. While investors now are seeking advanced forms of risk management, the beauty of diversification is that it has always been the best form of risk control. The error occurs in attributing a single year’s diversified returns to the performance of a lone asset class. That

Popular myth of a “lost decade” debunked with a diversified portfolio, which had positive returns and kept risk low for last 10 years
Global model portfolio

Index	YTD	Oct-10	2009	2008	2007	2006	2005	2004	2003	1 Year	3 Years	5 Years	10 Years	Cumulative 10 Year Return
Total Equity														
S&P 500	7.8	3.8	26.5	-37.0	5.5	15.8	4.9	10.9	28.7	16.5	-6.5	1.7	-0.0	-0.6
S&P MidCap 400	14.1	3.4	35.0	-37.3	6.7	9.0	11.3	15.2	34.0	25.8	-3.0	3.4	4.8	53.9
S&P SmallCap 600	12.3	4.2	23.8	-32.0	-1.2	14.1	6.7	21.6	37.5	24.9	-4.7	2.0	5.5	71.9
Global REITs	21.5	4.6	21.0	-41.5	-20.2	30.2	8.9	31.5	36.7	37.6	-9.9	-1.6	8.3	112.3
EAFE	5.1	3.6	32.5	-43.1	11.6	26.9	14.0	20.7	39.2	8.8	-9.1	3.8	3.6	39.2
Emerging Markets	8.7	2.8	93.5	-59.3	59.1	56.6	44.5	17.1	91.7	16.4	-6.7	19.0	17.4	363.0
Average	11.6	3.7	38.7	-41.7	10.2	25.4	15.0	19.5	44.6	21.7	-6.6	4.7	6.6	106.6
Total Fixed Income														
Corporate	10.9	0.1	18.7	-4.9	4.6	4.3	1.7	5.4	8.2	11.6	8.0	6.8	7.1	98.2
U.S. Treasury 20+	15.0	-4.6	-21.4	33.7	10.2	0.9	8.6	9.0	1.8	9.0	8.2	6.8	7.6	111.2
Global Aggregate	18.3	1.3	6.9	4.8	9.5	6.6	-4.5	9.3	12.5	6.9	7.2	7.3	7.5	104.4
High Yield	14.4	2.6	58.2	-26.2	1.9	11.8	2.7	11.1	29.0	19.4	9.5	9.1	8.6	120.6
Average	12.2	-0.2	51.6	1.9	6.5	5.9	2.1	8.7	12.9	11.7	8.2	7.5	7.7	108.6
60/40 Portfolio	**11.8**	**2.2**	**29.5**	**-24.3**	**8.8**	**17.6**	**9.9**	**15.2**	**31.9**	**17.7**	**-0.7**	**5.8**	**7.0**	**107.4**

Source: FactSet

is the trendy and often wrong notion to compare the current highest performing asset class to a well balanced diversified portfolio's return. This drives investors to load up on this "outperforming" asset class at exactly the wrong time; today, investors have poured money into bonds, and the outcome seems entirely — and unfortunately — predictable.

If gaming diversification is the crux of the problem, real diversification is the solution. An investor should own the market and should do so from a global perspective. In the table below, we show how a naïve but diversified 60/40 global strategy comprised of equities and bonds has delivered positive five- and ten-year returns through the end of October; even in 2010, an investor would be happy indeed with these results. The much talked about "lost decade" of equities is a fallacy used to scare investors into thinking the game is rigged. Investors would rather not hear that poor performance was the result of their attempts to game the system and their abandonment of the principles of diversification.

My point is that investors once again have gamed diversification by owning an excessive amount of bonds, and it is likely to end badly. There are four main reasons why I am confident in this, all of which bode well for equities to the detriment of bonds.

- The corporate profits surprise over the last five quarters is at a 20-year high and will likely continue.
- Merger and acquisition activity has gone global, demonstrating that risk and greed are back in vogue.
- The Fed is determined to stir inflation with a second round of quantitative easing (QE2), policy mistake or not.
- Midterm elections will eliminate the uncertainty in the tax and regulatory environment, relieving a major impediment to business capital expenditure and job formation.

So the question for investors: Trick (gaming diversification) or Treat (effective diversification)? Those who choose wisely will see that now is the time to get back in the markets toward a more broadly, globally diversified portfolio.

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