DIVERSIFIED PORTFOLIOS
PROVE THEIR VALUE IN TOUGH MARKETS

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We all have a sense of why we tolerate risky assets like stocks and speculative-grade bonds during downturns. This is an unavoidable byproduct of owning them during productive periods so that they can generate the bulk of our investment returns. No one has perfect foresight and trying to time entry and exit points can do more damage than good, so it's often best to wait out tough parts of the market cycle.

But why do we own less risky assets like high quality bonds? These offer lower returns, so the argument isn't as clear. They can also suffer downturns, albeit typically smaller and with lower frequency.

Investors should own both asset classes because of the diversification benefits they deliver together. It's not always exactly clear what this means, so we'll explore the subject.

A diversified investment portfolio generates returns from different sources that share varying degrees of correlation. When we use the term correlation, we're addressing how the price movements of two investments compare. A perfect positively correlated pair will move in lock step, while a perfect negatively correlated pair will move exactly opposite.

Ideally, an investment portfolio will include a mix of correlations—some partially aligned, others offsetting—helping to dampen the extreme price swings of any individual source while retaining the ability to generate sufficient returns. Owning stocks and high-quality bonds in the same portfolio helps accomplish this goal.

Let's look at some statistics. We'll use the S&P 500 Index and 10-year U.S. Treasury as proxies for risky assets and high-quality bonds, respectively, and consider their calendar-year performance from 1928 through 2017:

- Over these 90 periods, the S&P 500 had negative performance in 27% of years (or 24 periods)

- The 10-year Treasury was negative in 18% (or 16 periods)
- But they were only negative *together* in 3 years
- In contrast, they were positive together in 53 years

We can see the merits of owning different types of assets in this short study. The hard part is getting their proportions right. Here, affluent investors have a few advantages that help in finding the right balance.

Recognize the Risks | Different asset classes possess varying levels and types of risk. Generally, stocks are very volatile, while high-quality bonds are more sensitive to interest rate movements. Historically, a portfolio that's balanced in dollar terms will still derive the lion's share of volatility (and expected return) from its allocation to stocks.

Question Your Exposure | Affluent investors typically don't look to squeeze a high total return from their portfolios for income-generating purposes. This means being able to avoid high overall portfolio risk by striking a more conservative balance.

Take a Hands-off Approach | As mentioned, trying to time moving in and out of the market, particularly one that is volatile, is a futile endeavor. A more prudent approach is to establish a portfolio with a risk profile you can live with through market ups and downs.

Follow the Rules | If the objective is to stick with a market allocation, it's important to create a rebalancing play book when you construct a portfolio. It can include periodic calendar-driven rebalancing, or it might be driven by thresholds—like allocation bands (minimum and maximum shares). If you've stuck to the playbook, then rebalancing will prove its value in tough markets by ensuring you're not overexposed to risky assets (which would've increased their share of your portfolio in good times).

We all contend with an urge to push toward risky assets, especially during positive markets; there's a feeling that we're not being productive enough with our investments when we strike a conservative balance. Keep in mind, minimizing losses in downturns means preserving more capital for expansions.

Remember that diversification is intended to take the sting out of tough markets. You can think of an optimal allocation as a balance between how great a loss you're willing to accept in downturns and how much return you'd like to generate in advancing market environments.

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