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Diversification: It's Not Always Easy to Do the Right Thing

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Kevin P. Barr
Head of Investment Management Unit

Snapshot

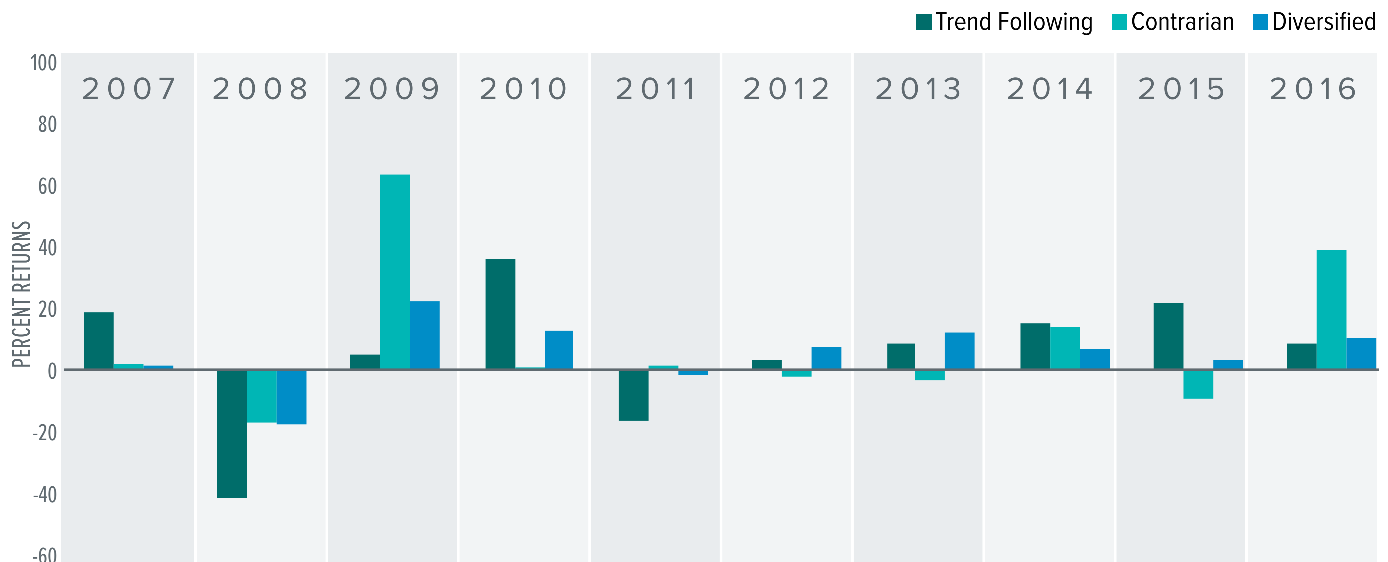
- Year in and year out, a single index will often outperform a well-diversified portfolio.
- Yet outperformance is difficult to predict—and over time, the diversified portfolio tends to perform well despite consistently falling short in any single year.
- Although it often leads to challenging conversations between financial advisors and investors, we believe diversification is the right approach.

Everybody loves a winner

In a world where the S&P/TSX Composite and S&P 500 Indexes set near all-time highs, the traditional well-diversified investment portfolio has fallen out of favour. While diversification is a time-tested method of portfolio construction that reduces risk (standard deviation) and delivers more consistent returns, it doesn't deliver the kind of attention-grabbing performance that has been making headlines. So, as is often the case during periods of strong equity performance, investors are generally left disappointed when comparing diversified portfolio returns with those of a single index.

Diversification rarely wins in any given year...

Many investors want to buy last year's winner; in the short-term, this strategy sometimes works well. Over the past 10 years, a trend-following strategy—one that invests in the top-performing asset class from the prior year—would have been the top performer 40% of the time. Similarly, a contrarian strategy—one that invests in the worst-performing asset class from the prior year—would also have been the top performer 40% of the time. A diversified strategy that invested equally in each asset class would have been the top performer only 20% of the time.



SOURCE: SEI/Bloomberg
Past performance is no guarantee of future results.

...But diversification also rarely loses

Looking solely at how often each strategy outperforms tells only part of the story. When considering the number of times each strategy was the bottom performer, we observe that both the trend-following and contrarian styles finished worst 40% of the time. The diversified portfolio finished last in just two out of 10 years, returning 0.83% in 2007 and 6.33% in 2014.

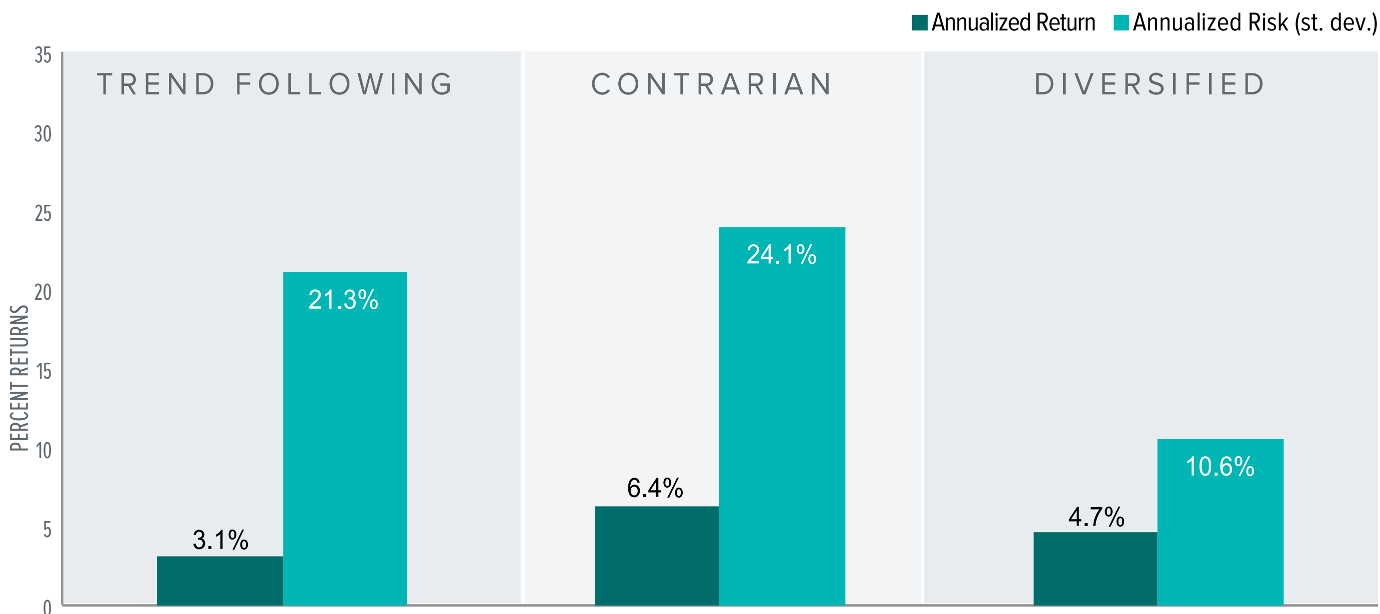
The proof

While the trend-following and contrarian strategies tend to have a greater opportunity to register headline-grabbing short-term outperformance, they also have the highest tendency to underperform. The diversified strategy may not have the same opportunity to achieve dramatic short-term gains, but it offers relative stability that helps avoid significant losses in a given year. Over longer, multi-year periods, a strategy that successfully avoids significant losses will tend to outperform and experience less volatility. This is the reason responsible financial advisors recommend diversification as the right thing to do for their clients.

If we examine the 10-year period as a whole, we observe that the contrarian strategy performed quite well, gaining 6.4% annualized—but with stunningly high volatility of 24.1% annually. It's worth noting that nearly all of these gains were generated during just two years, 2009 and 2016, when the strategy invested in highly volatile Canadian small companies. The trend-following strategy generated a significantly smaller gain of 3.1% annualized over the 10-year period, but had relatively better (but still high) volatility of 21.3% annually. The diversified strategy gained a solid 4.7% annualized and recorded a significantly lower volatility of 10.6% annually. If we look at return per unit of risk (simply dividing returns by volatility), we see the contrarian strategy returned 0.26% per unit of risk and the trend-following strategy returned just 0.15% per unit of risk. The diversified strategy, with its more consistent performance, returned 0.44% per unit of risk. It's clear that the diversified strategy has produced the top returns over the long term on a risk-adjusted basis.

It's not always easy to do the right thing

Over the past decade, prudent financial advisors have had to defend performance of well-diversified portfolios in eight out of 10 annual client meetings. While this task may seem daunting, just imagine having to defend a trend- following emerging-market equities portfolio after it plummeted by 41.6% in 2008. The contrarian strategy presented similar challenges, losing ground in three of four years, with losses of 2.2%, 3.5% and 9.6% in 2012, 2013 and 2015, respectively.



SOURCE: SEI/Bloomberg
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Chart disclosures

Asset-class returns are based on the same indices as indicated below. Performance begins 1/1/2007 and continues through 12/31/2016. In each of these years, “Trend Following” uses the current-year return of best-performing asset class of the previous year. “Contrarian” uses the current year return of the worst-performing asset class of the previous year. “Diversified” uses a return equal to the return of a portfolio of equally weighted asset-class returns in each year.

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
EME 18.20%	Short Term FI 8.55%	Canadian SC 62.37%	Canadian SC 35.1%	Real Return 18.34%	U.S. HY 16.18%	U.S. SC 48.13%	U.S. LC 23.44%	U.S. LC 21.03%	Canadian SC 38.48%
Canadian LC 9.83%	Canadian FI 6.41%	U.S. HY 55.77%	U.S. SC 20.23%	Canadian FI 9.67%	EME 15.61%	U.S. LC 42.04%	U.S. SC 14.34%	EAFE Equity 18.95%	Canadian LC 21.08%
Cash 4.26%	Cash 2.56%	EME 51.58%	Canadian LC 17.6%	Short Term FI 4.65%	EAFE Equity 14.71%	EAFE Equity 31.01%	Real Return 13.18%	U.S. SC 14.63%	U.S. SC 17.11%
Short Term FI 4.09%	Real Return 0.42%	Canadian LC 35.05%	U.S. HY 14.83%	U.S. HY 4.49%	U.S. LC 13.84%	Canadian LC 12.99%	Canadian LC 10.55%	Canadian FI 3.52%	U.S. HY 16.97%
Canadian FI 3.68%	U.S. SC -17.10%	Real Return 14.49%	EME 12.67%	U.S. LC 4.01%	U.S. SC 13.77%	U.S. HY 8.19%	Canadian FI 8.78%	Real Return 2.79%	U.S. LC 8.17%
Real Return 1.59%	Commodities -19.5%	EAFE Equity 11.9%	Real Return 11.08%	Cash 0.90%	Canadian LC 7.18%	Canadian SC 7.59%	EME 6.62%	Short Term FI 2.61%	Commodities 7.90%
U.S. HY 1.30%	U.S. LC -21.9%	U.S. LC 9.06%	Commodities 10.73%	U.S. SC -1.80%	Canadian FI 3.59%	EME 3.93%	EAFE Equity 3.66%	EME 2.03%	EME 7.34%
Canadian SC 0.89%	U.S. HY -28.3%	U.S. SC 7.99%	U.S. LC 10.03%	Canadian LC -8.70%	Real Return 2.85%	Short Term FI 1.74%	U.S. HY 3.28%	Cash 0.59%	Real Return 2.85%
Commodities -1.4%	EAFE Equity -29.1%	Canadian FI 5.41%	Canadian FI 6.74%	EAFE Equity -9.90%	Short Term FI 2%	Cash 0.96%	Short Term FI 3.06%	U.S. HY -4.50%	Canadian FI 1.66%
EAFE Equity -5.7%	Canadian LC -33%	Short Term FI 4.53%	Short Term FI 3.56%	Commodities -11.10%	Cash 0.90%	Canadian FI -1.10%	Cash 0.88%	Canadian LC -8.30%	Short Term FI 1.01%
U.S. LC -10.20%	EME -41.6%	Commodities 0.97%	EAFE Equity 2.12%	EME -16.40%	Canadian SC -2.20%	Commodities -3.40%	Canadian SC -2.30%	Commodities -9.60%	Cash 0.53%
U.S. SC -16.50%	Canadian SC -45.4%	Cash 0.36%	Cash 0.42%	Canadian SC -16.40%	Commodities -3.20%	Real Return -13%	Commodities -9.50%	Canadian SC -13.30%	EAFE Equity -2.4%

SOURCE: SEI, Morningstar

Index definitions

Asset categories represented by: Canadian LC S&P/TSX Composite Index (CAD), U.S. LC Russell 1000 Index (CAD), EAFE Equity MSCI EAFE Index (Net) (CAD), EME MSCI Emerging Markets Index (Net) (CAD), Canadian FI FTSE TMX Canada Universe Overall Bond Index (CAD), Short Term Bond FTSE TMX Canada ST Bond (CAD), Real Return FTSE TMX Canada RRB - Universe Overall Bond Index (CAD), Cash FTSE TMX Canada 30-Day T-Bill Index (CAD), U.S. HY BofA Merrill Lynch US High Yield Constrained Index (CAD), Commodities Bloomberg Commodity Total Return Index (CAD), Canadian SC S&P/TSX SmallCap Index (CAD), U.S. SC Russell 2000 Index (CAD). Performance as of 12/31/2016.

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