

Diversification means usually being a little disappointed

Chart of the Month - August 2018

“So the last shall be first, and the first last”
(King James Bible, Mathew 20:16)

Harry Markowitz, in a 1952 essay in the Journal of Finance, laid out the mathematical framework for what became known as “Modern Portfolio Theory”. Thirty-eight years later, Markowitz shared the Nobel Prize in economics for proving that diversification works – the math showed that owning a mix of assets with different risk and return characteristics can lead to a better investment portfolio over time.

Markowitz’s math, however, was Greek to many investors. It wasn’t until 1999 that a consulting firm named Callan helped put Markowitz’s insights into visual form. Each year Callan ranks asset classes, each with its own color, based on its previous year’s return. We have added a “Diversified” box, in blue, to represent a basket of these assets. It is simply known as ‘the quilt’. Here is a portion of their chart spanning the previous decade:

Investment Returns by Asset Class^a

2008-2017

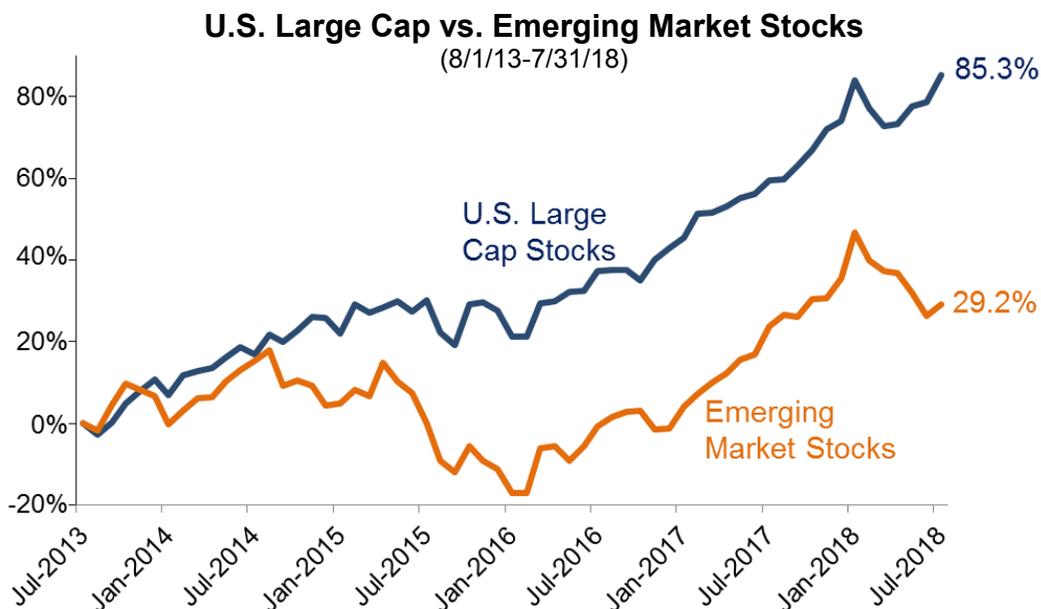
2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Cumulative Returns	Annualized Returns
Global Agg Bond 7.2%	Emerging Market 78.5%	Gold 29.5%	Gold 10.1%	Emerging Market 18.2%	US Small Cap 38.8%	US Large Cap 13.7%	US Large Cap 1.4%	US Small Cap 21.3%	Emerging Market 37.3%	US Small Cap 130.5%	US Small Cap 8.7%
Gold 5.8%	Int'l Developed 31.8%	US Small Cap 26.9%	US Agg Bond 7.8%	Int'l Developed 17.3%	US Large Cap 32.4%	US Agg Bond 6.0%	US Agg Bond 0.5%	US Large Cap 12.0%	Int'l Developed 25.0%	US Large Cap 89.2%	US Large Cap 6.6%
US Agg Bond 5.2%	US Small Cap 27.2%	Emerging Market 18.9%	Global Agg Bond 6.1%	US Small Cap 16.3%	Int'l Developed 22.8%	Diversified 5.6%	Cash 0.0%	Hard Assets 11.8%	US Large Cap 21.8%	Diversified 73.9%	Diversified 5.7%
Cash 1.8%	US Large Cap 26.5%	Hard Assets 16.8%	US Large Cap 2.1%	US Large Cap 16.0%	Diversified 14.7%	US Small Cap 4.9%	Int'l Developed -0.8%	Emerging Market 11.2%	Diversified 16.0%	Gold 56.3%	Gold 4.6%
Diversified -22.9%	Gold 24.4%	US Large Cap 15.1%	Cash 0.1%	Diversified 11.5%	Cash 0.0%	Global Agg Bond 1.7%	Diversified -1.3%	Gold 8.6%	US Small Cap 14.6%	US Agg Bond 48.1%	US Agg Bond 4.0%
US Small Cap -33.8%	Diversified 23.0%	Diversified 11.2%	Diversified -0.1%	Gold 7.1%	US Agg Bond -2.0%	Cash 0.0%	Global Agg Bond -2.7%	Diversified 6.8%	Gold 13.1%	Global Agg Bond 38.9%	Global Agg Bond 3.3%
Hard Assets -35.6%	Hard Assets 18.9%	Int'l Developed 7.8%	US Small Cap -4.2%	US Agg Bond 4.2%	Emerging Market -2.6%	Gold -1.7%	US Small Cap -4.4%	US Agg Bond 2.6%	Global Agg Bond 7.0%	Int'l Developed 21.2%	Int'l Developed 1.9%
US Large Cap -37.0%	Global Agg Bond 6.1%	US Agg Bond 6.5%	Int'l Developed -12.1%	Global Agg Bond 4.1%	Global Agg Bond -2.6%	Emerging Market -2.2%	Gold -10.4%	Global Agg Bond 2.2%	US Agg Bond 3.5%	Emerging Market 18.2%	Emerging Market 1.7%
Int'l Developed -43.4%	US Agg Bond 5.9%	Global Agg Bond 5.0%	Hard Assets -13.3%	Cash 0.1%	Hard Assets -9.5%	Int'l Developed -4.9%	Emerging Market -14.9%	Int'l Developed 1.0%	Hard Assets 1.7%	Cash 3.4%	Cash 0.3%
Emerging Market -53.3%	Cash 0.1%	Cash 0.1%	Emerging Market -18.4%	Hard Assets -1.1%	Gold -28.0%	Hard Assets -17.0%	Hard Assets -24.7%	Cash 0.3%	Cash 0.8%	Hard Assets -50.7%	Hard Assets -6.8%

Data Source: Bloomberg. The composition of the "Diversified" portfolio is: 34% S&P 500 Total Return (TR) Index, 3% Russell 2000 TR, 16% MSCI EAFE TR, 7% MSCI Emerging Market TR, 33% Barclays U.S. Aggregate Bond Index, 4% JP Morgan Global Aggregate Bond Index, 2% Bloomberg Commodity Index and 1% Bloomberg Barclays U.S. Treasury Bills (1-3 month) Index, rebalanced annually. Please see disclosures for additional information about the indices listed within this chart.

Callan’s chart helps show investors a few things:

1. Investment returns among asset classes can vary widely in any given year.
2. While some investment classes have long winning streaks, in general the rankings mean revert. In other words, yesterday’s losers become tomorrow’s winners.
3. Owning a balanced and diversified portfolio creates a smoother return stream. In the process, though, you have some holdings to cheer and others to scorn at any given time. The trick is to stay diversified and use the market’s volatility to your advantage by rebalancing – sell a bit of today’s winner to buy today’s loser to win over the long term.

Over the last five years, Emerging Markets have trailed returns of the U.S. Large Cap stocks with the gap widening further during 2018. Many investors are selling in frustration.



Data Source: Bloomberg. U.S. Large Cap stocks represented by the S&P 500 Total Return (TR) Index and Emerging Market Stocks represented by the MSCI Emerging Market TR Index.

In our Global Asset Allocation strategies, we recently rebalanced as part of our discipline by modestly selling some U.S. assets and buying Emerging Markets. We continue to believe that the lessons of Markowitz's math and Callan's chart still hold true: staying appropriately diversified will serve us and our clients well over the long term.

Market Performance^c

Index	July 2018	Year to Date (1/1/18-7/31/18)	One Year (8/1/17-7/31/18)
S&P 500 Index	3.7%	6.5%	16.2%
MSCI EAFE Index	2.5%	-0.4%	6.4%
Barclays U.S. Aggregate Bond Index	0.0%	-1.6%	-0.8%
JP Morgan Global Aggregate Bond Index	-0.1%	-1.7%	-0.5%
Bloomberg Commodity Index	-2.1%	-2.1%	2.7%
Gold (\$/oz)	-2.3%	-6.1%	-3.6%

Notes and Disclosures

a. Data Source: Bloomberg. Returns for the asset classes listed in this chart represented by the following Indices: U.S. Large Cap is represented by the S&P 500 Total Return (TR) Index, US Small Cap is represented by the Russell 2000 TR, Int'l Developed is represented by the MSCI EAFE TR, Emerging Market is represented by the MSCI Emerging Market TR, US Agg Bond is represented by the Bloomberg Barclays US Aggregate Bond Index, Global Agg Bond is represented by the J.P. Morgan Global Aggregate Bond Index, Gold is represented by the price of gold (\$) per Troy Ounce, Hard Assets is represented by the Bloomberg Commodity Index, and Cash is represented by the Bloomberg Barclays U.S. Treasury Bills (1-3 month) Index. The "Diversified" portfolio was adapted from the Morningstar Moderate Target Risk Allocation, but was altered in the following ways - all U.S. Large Cap, U.S. Mid Cap and U.S. REIT exposure was placed in the S&P 500 TR Index, all U.S. Small Cap exposure was placed in the Russell 2000 TR, all international developed stock and international REIT exposure was placed in the MSCI EAFE TR, all U.S. bond exposure was placed in the Bloomberg Barclays U.S. Aggregate Bond Index, all emerging market bond exposure was placed in the J.P. Morgan Global Aggregate Bond Index, and all TIPS exposure was placed in the Bloomberg Commodity Index.

b. Source: Bloomberg. Total Return indices.

Past performance is no indication of future returns. Investors cannot invest directly in an index.

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