Weekly Market Commentary

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Is Diversification Dead?

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Highlights

In the 2008 bear market, almost no asset class was spared sharp losses. The performance of 2008 begs the question: Is diversification dead? Fortunately, the answer is no; we just have to look in non-traditional places to find it.

Some types of alternative investments can help deliver the effective diversification and low correlations previously found among traditional investments. These strategies passed a critical test in 2008.

We continue to recommend that a significant portion of a portfolio, across all risk objectives, be allocated to alternative strategies. One of the most important lessons of 2008 is that traditional assets alone may not provide adequate diversification.

One of the most disappointing aspects of the financial crisis, recession, and bear market of 2008 where stocks posted a peak-to-trough decline of just over 50%, was the fact that nearly all investments declined similarly. Diversification failed when it was most needed.

Correlation, the measure of how coordinated the movements among investments are, usually rises during downturns. Performance is often driven more by unique, asset-specific factors during upwardly sloping markets, but during a downturn investments are more likely to be driven by a sudden change in "big picture" factors common to all of them. The 2008 markets took this rise in correlation to a new extreme. [Chart 1]

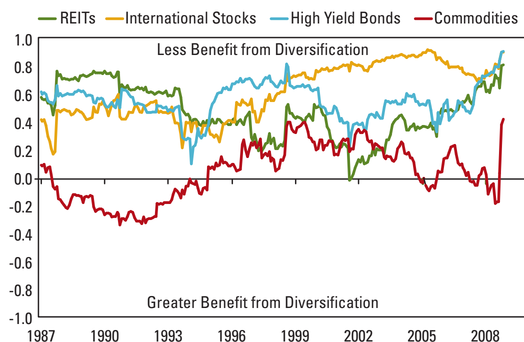
Not all assets saw their correlation rise during past recessions, such as those in 1991 and 2001; some asset classes remained effective diversifiers of risk. For example, during the 2000-2002 bear market—which resulted in a 49% decline in the S&P 500 index and included a recession—asset classes such as REITs, Commodities, Small Cap Value stocks, and even various sectors of the Large Cap stock market provided diversification benefits, as the correlations of these asset classes with the S&P 500 remained relatively low. [Chart 2]

In the current bear market, almost no asset class was spared sharp losses. From peak-to-trough, the stock market (measured by the S&P 500) fell 52%, commodities (measured by the CRB/Reuters Commodity Index) fell 52%, international stocks (measured by the MSCI EAFE index) fell 56%, emerging market stocks (measured by the MSCI Emerging Market Index) fell 64%, preferred stocks (measured by the S&P Preferred Stock Index) fell 57%, REITs (measured by the NAREIT composite index) fell 70%, High Yield bonds (measured by the Barclay's High Yield Index) fell 35%. In addition, while the Financials sector was the source of the bear market's problems, all sectors fell significantly, and the correlations rose as they traded as one monolithic asset class. Only Treasury debt, the lone safe haven, was spared losses and maintained a negative correlation with the stock market. [Chart 3]

The market performance of 2008 begs the question: Is diversification dead? Fortunately, the answer is no; we just have to look in non-traditional places to find it.

Correlations are rising among traditional asset classes as the globally common factor of credit increasingly affects all facets of the traditional markets. However, just as the old tools of portfolio management are rendered less effective, new tools are ready to be put to use. It is time to look beyond traditional investments. Some types of alternative investments can help deliver the effective diversification and the low correlations

1 Asset Class Correlations Have Risen Sharply
Rolling 36-Month Correlation of S&P 500 and Various Asset Classes

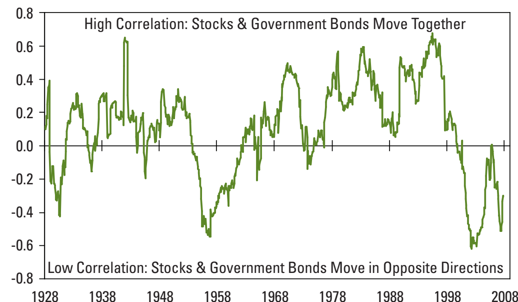


Source: LPL Financial Research, Bloomberg

2 Sector Correlations Have Risen Sharply
Rolling 52-Week Correlation of Each of the 10 S&P 500 Sectors with the S&P 500 Index

Source: LPL Financial Research, Bloomberg

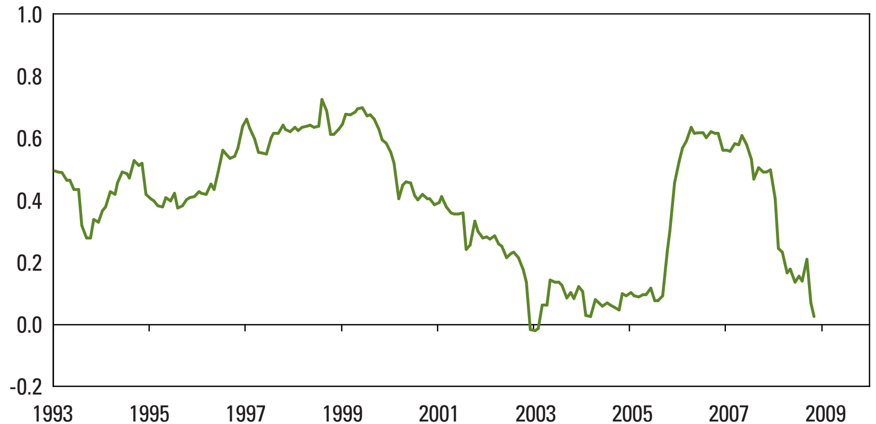
3 Treasury Debt was the Lone Diversifier
Rolling 36-Month Correlation of the S&P 500 and Ibbotson Intermediate Term Government Bond Index



Source: LPL Financial Research, Bloomberg, Ibbotson Associates

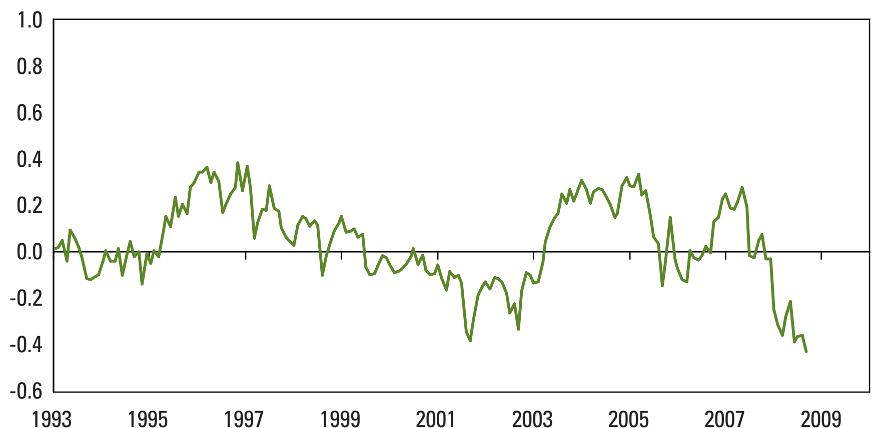
previously found among traditional investments. These strategies passed a critical test in 2008. Alternative mutual fund strategies, such as the Global Macro and Managed Futures styles of investing, provided a low or even negative correlation with the stock market in 2008, and were useful for helping manage risk and return in portfolios. (Managed Futures are also known as Commodity Trading Advisor (CTA) investments.) Keep in mind, Alternative Investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of Alternative Investments may accelerate the velocity of potential losses.

Global Macro Style of Investing Maintained Low Correlation with Stocks
Rolling 36 Month Correlation of HFRI Global Macro Index and S&P 500



Source: LPL Financial Research, Bloomberg

Managed Futures Style of Investing Maintained Low Correlation with Stocks
Rolling 36 Month Correlation of CISDM Commodity Trading Advisor Index and S&P 500



Source: LPL Financial Research, Bloomberg

We continue to recommend that a significant portion of a portfolio, across all risk objectives, be allocated to alternative strategies. The benefits of diversification and low correlations among assets are the only "free lunches" when it comes to investing. The success of efforts to seek significantly superior risk and return by combining diverse assets depends on correlations remaining low when they are needed most. One of the most important lessons of 2008 is that traditional assets alone may not provide adequate diversification.

IMPORTANT DISCLOSURES

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, potential liquidity. There is no assurance that the investment objective will be attained.

Investing in Mutual Funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlines in the prospectus.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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