MARKET OBSERVATIONS
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Diversification

Diversification is a sound investing principle that is employed to reduce overall portfolio risk. But diversification arises as well from another investing principle. Investing itself is a means to an end, e.g., providing capital for a home purchase, generating income in retirement, growing assets for a child's or grandchild's education. Most households pursue more than one end at any time. These diverse pursuits can bring different investing implications due to factors such as time horizon and tolerance for risk. A perspective of diversification's dual role can provide investment implications.

PERSPECTIVE

Diversification parameters lend themselves to a series of "3's" as shown in Table I. Different combinations lead to different portfolio structures, for example:

Preservation Goal + Short Horizon + Low Risk => Money Markets

Income Goal + Medium Horizon + Moderate Risk => Bonds

Growth Goal + Long Horizon + High Risk => Stocks

Portfolio structures follow from the inherent return and risk characteristics of component investments. Table II provides characteristics for U.S. indexes representing broad asset classes. Variability of rolling one-year returns is a proxy for risk and is expressed as ±one standard deviation of the respective return averages. The fifty-year period shows the traditional relative relationships expected of higher risks accompanying higher returns. The ten-year period shows the impact of historically low interest rates dragging down money market and bond returns while steady growth elevated stock returns. Last year's data shows how at odds 2018 outcomes were with much of history.

As multiple goals often are pursued simultaneously, a portfolio diversified among asset classes is appropriate. 2018 showed how longer-term relationships of return and risk can break down. Table III provides the frequency of each of the three asset classes outperforming over different time periods. In the last ten years, not only were absolute returns skewed in favor of stocks but also stock outperformance occurred with greater frequency. The fifty-year experience shows meaningful frequencies when taking risk is not rewarded. As a result, portfolios cannot be structured in a "robo" manner to achieve simple goals let alone multiple ones.

INVESTMENT IMPLICATIONS

Portfolio structure must follow from the identification of specific goals, time horizons and risk tolerances. Once these parameters have been identified, portfolio structure can be guided but not mandated by return and risk relationships among asset classes, both historical and expected. As investing is a means to an end, so too are measures of portfolio risk. The risk that matters for any investor is falling short of goals – not being able to buy the dream house, not having the level of income to support the desired retirement lifestyle, not attending the preferred college. Understanding the parameters of diversification and following disciplined planning and investment processes can lower the risk of falling short.

TABLE I

DIVERSIFICATION PARAMETERS

GOALS
Preservation, Income, Growth

HORIZONS
Short, Medium, Long

RISK TOLERANCES
Low, Moderate, High

ASSET CLASSES
Money Markets, Bonds, Stocks

TABLE II

AVERAGE ONE-YEAR RETURNS

	Last Year	Last Ten Years	Last Fifty Years
Money Markets	+1.9%	+0.3%	+4.9%
Bonds	+0.0%	+3.7%	+7.4%
Stocks	-5.3%	+12.4%	+11.6%

ONE-YEAR RETURN VARIABILITY

	Last Year	Last Ten Years	Last Fifty Years
Money Markets	N.A.	±0.4%	±3.5%
Bonds	N.A.	±3.4%	±6.5%
Stocks	N.A.	±16.1%	±17.3%

TABLE III

ONE-YEAR RETURN FREQUENCY

	Last Year	Last Ten Years	Last Fifty Years
Stocks > Bonds	No	73%	66%
Bonds > Money Markets	No	80%	66%
Stocks > Money Markets	No	84%	70%