Diversification: The Boring Winner

APRIL 2022

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SNAPSHOT

- Year in and year out, a single asset class will often outperform a well-diversified portfolio.
- Yet outperformance of any single asset class is notoriously difficult to predict—and a diversified portfolio will tend to outperform over the long run, especially in risk-adjusted terms.
- Although the middle-of-the-road performance tendencies of diversified strategies can lead to challenging conversations with some clients, diversifying is still the right thing to do.

In a world where the best- and worst-performing asset classes tend to dominate the headlines, it's easy to lose sight of the fact that a diversified investment portfolio is generally the most reliable approach for meeting long-term investment objectives. Diversification is a time-tested component of portfolio construction, especially through the lens of risk-adjusted returns in terms of Sharpe ratios. Historically, the result is a less volatile portfolio that tends to produce something close to middle-of-the-road performance year in and year out. This is in contrast to the best- and worst-performing asset classes, which often generate significant media attention despite volatility in returns and market leadership—hence the sentiment that diversification is rather boring.

Diversification rarely wins in any given year...

By design, diversified portfolios hold a mix of asset classes, some of which outperform and some of which underperform in a given year. As a result, diversified portfolios will never beat the top-performing asset class in any given year. However, it's notoriously difficult for investors to consistently pick top-performing asset classes. Nevertheless, to some investors, more-stable diversified strategies lack the appeal of flavor-of-the-month champions like the high-flying technology stocks or rapidly rising emerging markets. This point of view arises from some well-known cognitive and emotional biases, which we have covered at length in our series of Behavioral Finance papers.

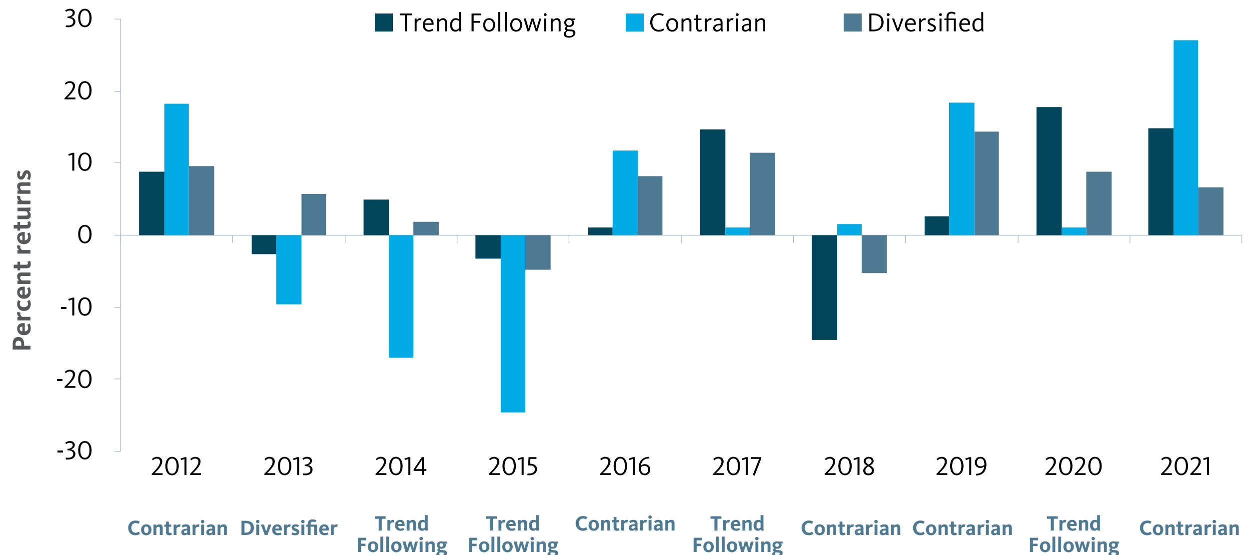
To counter these biases, we developed a framework based on our analysis of three highly simplified investment strategy types (described below)—which has demonstrated the power of diversification.

Trend-Following Strategy: Invests in the top-performing asset class of the prior year

Contrarian Strategy: Invests in the worst-performing asset class of the prior year

Diversified Strategy: Invests equally in all available asset classes

We found that over the last 10 years, the Contrarian strategy beat the other two strategies 50% of the time. The Trend Following approach won in three of those years. And the diversified strategy only came out on top in only one of those 10 years.

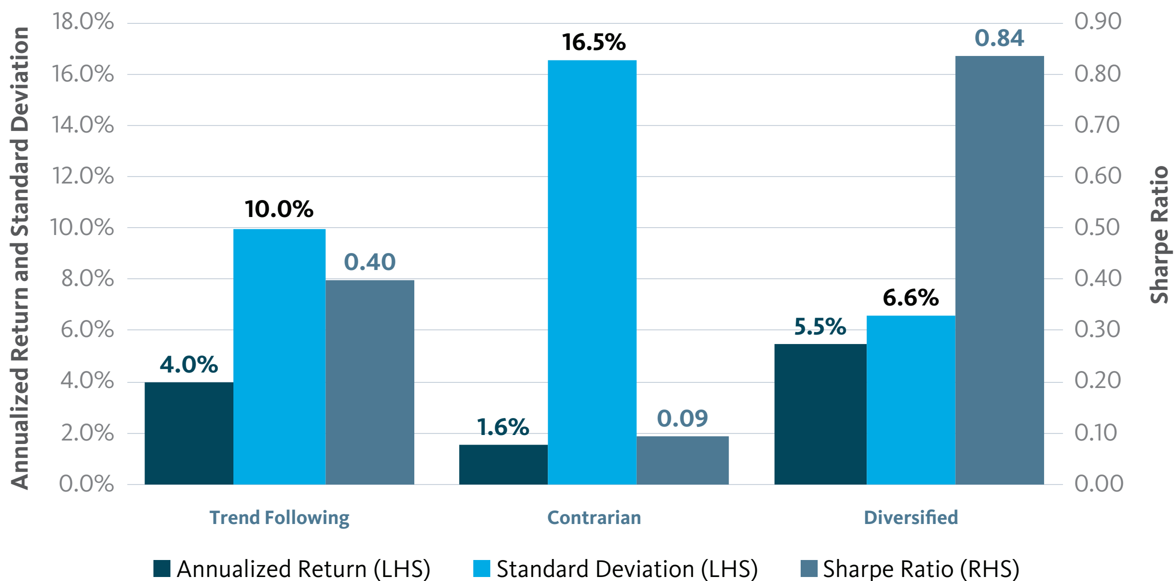


Source: SEI/Bloomberg
Past performance is no guarantee of future results.

...But diversification also rarely loses, and wins over time

We've already established that a diversified strategy can't beat the top-performing asset class in a given year; but, by definition, it can't be the worst performer either.

In terms of risk-adjusted returns, despite rarely beating the two other strategies in a single year, the diversified approach has won, hands down, over the past decade. While the trend-following and contrarian strategies produced moderate returns overall with much higher volatility, the diversified approach provided a respectable overall return with far less volatility and, as a result, much higher risk-adjusted returns.



Source: SEI/Bloomberg, 10 years as of 12/31/21
Past performance is no guarantee of future results.

It’s not always easy to do the right thing

This tells us that trend-following and contrarian strategies are double-edged swords; while they may offer a better chance of outperforming many asset classes and diversified portfolios, they also impose a higher probability of significantly underperforming. Meanwhile, the relative stability conferred by a diversified strategy may help to avoid significant losses while reducing the overall volatility of the investment experience. And portfolios that can avoid extreme losses while enjoying lower volatility tend to outperform in the long run. This is why we continue to preach diversification: it may seem boring, but the past 10 years of performance illustrate that diversified strategies have offered benefits that the other approaches have failed to provide.

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Emerging Equity 18.2%	US Small Cap 38.8%	Long Duration 19.3%	Short Duration 1.0%	US Small Cap 21.3%	Emerging Equity 37.3%	Cash 2.1%	US Large Cap 30.7%	US Small Cap 20.0%	US Large Cap 28.2%
International Equity 17.3%	US Large Cap 31.5%	US Large Cap 13.0%	US Large Cap 0.7%	High Yield 17.5%	International Equity 25.0%	Short Duration 1.5%	US Small Cap 25.5%	Emerging Equity 18.3%	Commodities 27.1%
Emerging Debt 17.1%	International Equity 22.8%	Core Fixed 6.0%	Core Fixed 0.5%	Commodities 11.8%	US Large Cap 21.1%	TIPS 0.4%	International Equity 22.0%	US Large Cap 17.8%	US Small Cap 14.8%
US Small Cap 16.3%	High Yield 7.4%	US Small Cap 4.9%	Cash 0.2%	US Large Cap 11.2%	US Small Cap 14.6%	Core Fixed 0.0%	Long Duration 19.6%	Long Duration 16.1%	International Equity 11.3%
High Yield 15.5%	Cash 0.2%	High Yield 2.5%	TIPS -0.1%	Emerging Equity 11.2%	Emerging Debt 12.7%	High Yield -2.3%	Emerging Equity 18.4%	International Equity 7.8%	TIPS 5.5%
US Large Cap 15.2%	Short Duration -0.2%	Short Duration 1.2%	International Equity -0.8%	Emerging Debt 10.0%	Long Duration 10.7%	Long Duration -4.7%	High Yield 14.4%	Core Fixed 7.5%	High Yield 5.3%
Long Duration 8.8%	TIPS -2.0%	Emerging Debt 0.9%	Long Duration -3.3%	Long Duration 6.7%	High Yield 7.5%	US Large Cap -4.9%	Emerging Debt 14.3%	High Yield 6.1%	Cash 0.2%
Core Fixed 4.2%	Core Fixed -2.0%	Cash 0.2%	US Small Cap -4.4%	TIPS 3.1%	Core Fixed 3.5%	Emerging Debt -5.2%	Core Fixed 8.7%	TIPS 5.7%	Short Duration -1.1%
TIPS 2.7%	Emerging Equity -2.6%	TIPS -1.1%	High Yield -4.6%	Core Fixed 2.6%	Commodities 1.7%	US Small Cap -11.0%	Commodities 7.7%	Short Duration 4.3%	Core Fixed -1.5%
Short Duration 0.9%	Emerging Debt -7.1%	Emerging Equity -2.2%	Emerging Debt -6.9%	Short Duration 1.1%	Cash 1.1%	Commodities -11.2%	TIPS 5.1%	Emerging Debt 4.0%	Long Duration -2.5%
Cash 0.5%	Long Duration -8.8%	International Equity -4.9%	Emerging Equity -14.9%	International Equity 1.0%	TIPS 0.8%	International Equity -13.8%	Short Duration 4.2%	Cash 1.1%	Emerging Equity -2.5%
Commodities -1.1%	Commodities -9.5%	Commodities -17.0%	Commodities -24.7%	Cash 0.7%	Short Duration 0.7%	Emerging Equity -14.6%	Cash 2.6%	Commodities -3.1%	Emerging Debt -5.3%

Source: SEI/Bloomberg

Chart disclosures

Asset-class returns are based on the same indexes as indicated below. Performance begins 1/1/2012 and continues through 12/31/2022. In each of these years, “Trend Following” uses the current-year return of the 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.

Definitions

Sharpe Ratio: A measurement of the reward per unit of risk, which is calculated by using standard deviation (risk) and excess return over a risk-free index.

Standard deviation: Statistical measure of historical volatility. A statistical measure of the distance a quantity is likely to lie from its average value. It is applied to the annual rate of return of an investment, to measure the investment's volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment's return will be. A standard deviation of zero would mean an investment has a return rate that never varies.

Index definitions

US Large = Russell 1000 Index, US Small = Russell 2000 Index, Int'l Equity = MSCI EAFE Index, EM Equity = MSCI Emerging Markets Index, Core Fixed = Bloomberg US Aggregate Bond Index, High Yield = Bloomberg US Corporate High Yield Total Return Index, EM Debt = 50% JP Morgan EMBI Global Diversified Index/50% JP Morgan GBI EM Global Diversified Index, TIPS = Bloomberg 1-5 Year US TIPS Index, Commodities = Bloomberg Commodity Total Return Index, Long Duration = Bloomberg US Long Government/Credit Index, Short-Duration = ICE BofA 1-3 Year US Treasury Index, Cash = ICE BofA USD 3-Month Deposit Offered Rate Constant Maturity Index. Sources: Bloomberg, SEI. Past performance is not a guarantee of future results.

Bloomberg 1-5 Year US TIPS Index: measures the performance of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of one to five years.

Bloomberg US Long Government/Credit Index: measures the investment return of all medium and larger public issues of U.S. Treasury, agency, investment-grade corporate and investment-grade international dollar-denominated bonds with maturities longer than 10 years. The average maturity is approximately 20 years.

Bloomberg Commodity Total Return Index: composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13 week (3 Month) U.S. Treasury Bills.

Bloomberg US Aggregate Bond Index: composed of U.S. securities in Treasury, government-related, corporate and securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $250 million.

Bloomberg US Corporate High Yield Index: measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging-markets country of risk are excluded.

ICE BofA 1-3 Year US Treasury Index: an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government having a maturity of at least one year and less than three years.

ICE BofA USD 3-Mon Deposit Offered Rate Constant Maturity Index: based on the assumed purchase of a synthetic instrument having three months to maturity and with a coupon equal to the closing quote for 3-month LIBOR. That issue is sold the following day (priced at a yield equal to the current day closing 3-month LIBOR rate) and is rolled into a new 3-month instrument. The index, therefore, will always have a constant maturity equal to exactly three months.

JP Morgan GBI Emerging Markets Global Diversified: a total return, unmanaged trade-weighted index for U.S. dollar-denominated emerging-market bonds, including sovereign debt, quasi-sovereign debt, Brady bonds, loans and Eurobonds.

JP Morgan EMBI Global Diversified Index: tracks the performance of external debt instruments (including U.S.-dollar-denominated and other external-currency-denominated Brady bonds, loans, eurobonds and local-market instruments) in emerging markets.

MSCI Emerging Markets Index: a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.

MSCI EAFE Index: an unmanaged, market-capitalization-weighted equity index that represents the developed world outside North America.

Russell 1000 Index: measures the performance of 1,000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

Russell 2000 Index: measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index: an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

Important Information

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