The Quest for Diversification

Choosing your asset class baskets

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One of the greatest and most enduring pieces of personal advice ever published can be found in Miguel de Cervantes' classic novel, Don Quixote, as translated in 1712 by Peter Motteux. In Chapter 23, titled "Of What Befell Don Quixote in the Sierra Morena, which was One of the Rarest Adventures in this Veracious History," Don Quixote and his faithful squire Sancho Panza are confronted by danger, to which Señor Panza advises:

> *"It is the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket."*

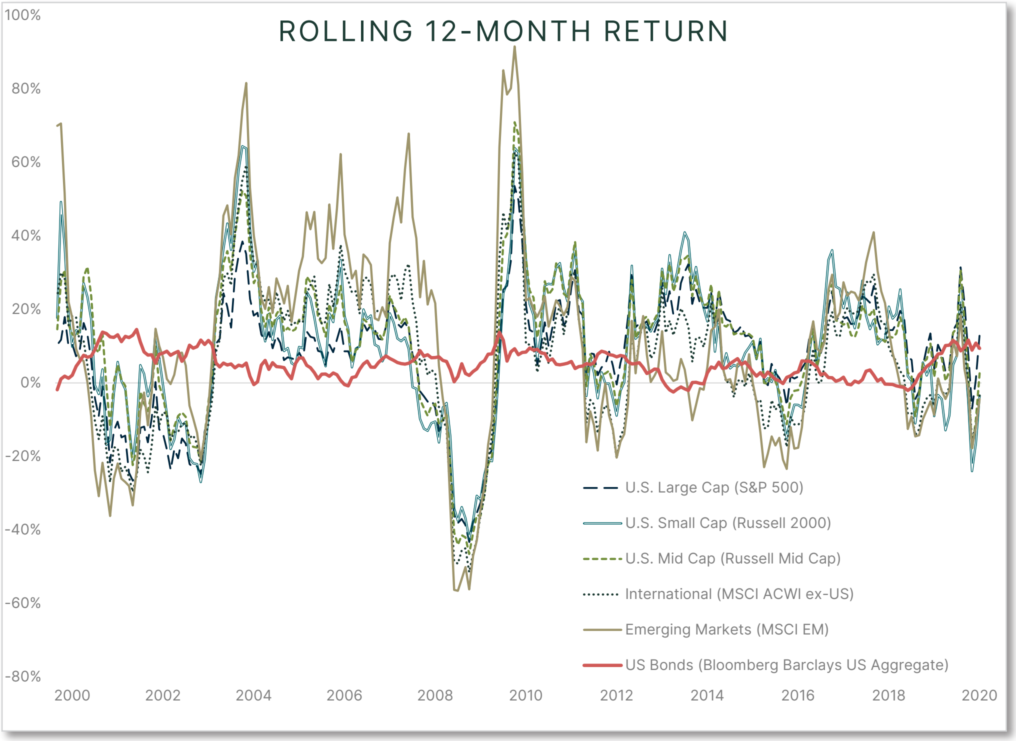
Over the centuries, Señor Panza's advice has also been widely recognized as being applicable to the topic of investing. However, for those who would wish to put this advice into practice, an important detail is missing: exactly how many investment "baskets" — or "asset classes" —should a wise investor use? Two? Seven? Twelve? How does one decide?

To tackle this question, it's best to begin by considering the underlying assumption that gives value to diversification. When beginning the project of diversifying portfolios, it's assumed that:

> *If one asset class declines, the others should still appreciate.*

But what happens if the other asset classes also decline in concert? Then, the hoped-for benefits of diversification will fail to materialize. To achieve long-term portfolio risk management, the asset classes should ideally perform independently of each other, so they don't all fail at the same time. Unfortunately, history shows that in practice, this is easier said than done, since many seemingly different types of investments have historically tended to deliver surprisingly similar performance results (see Figure 1).

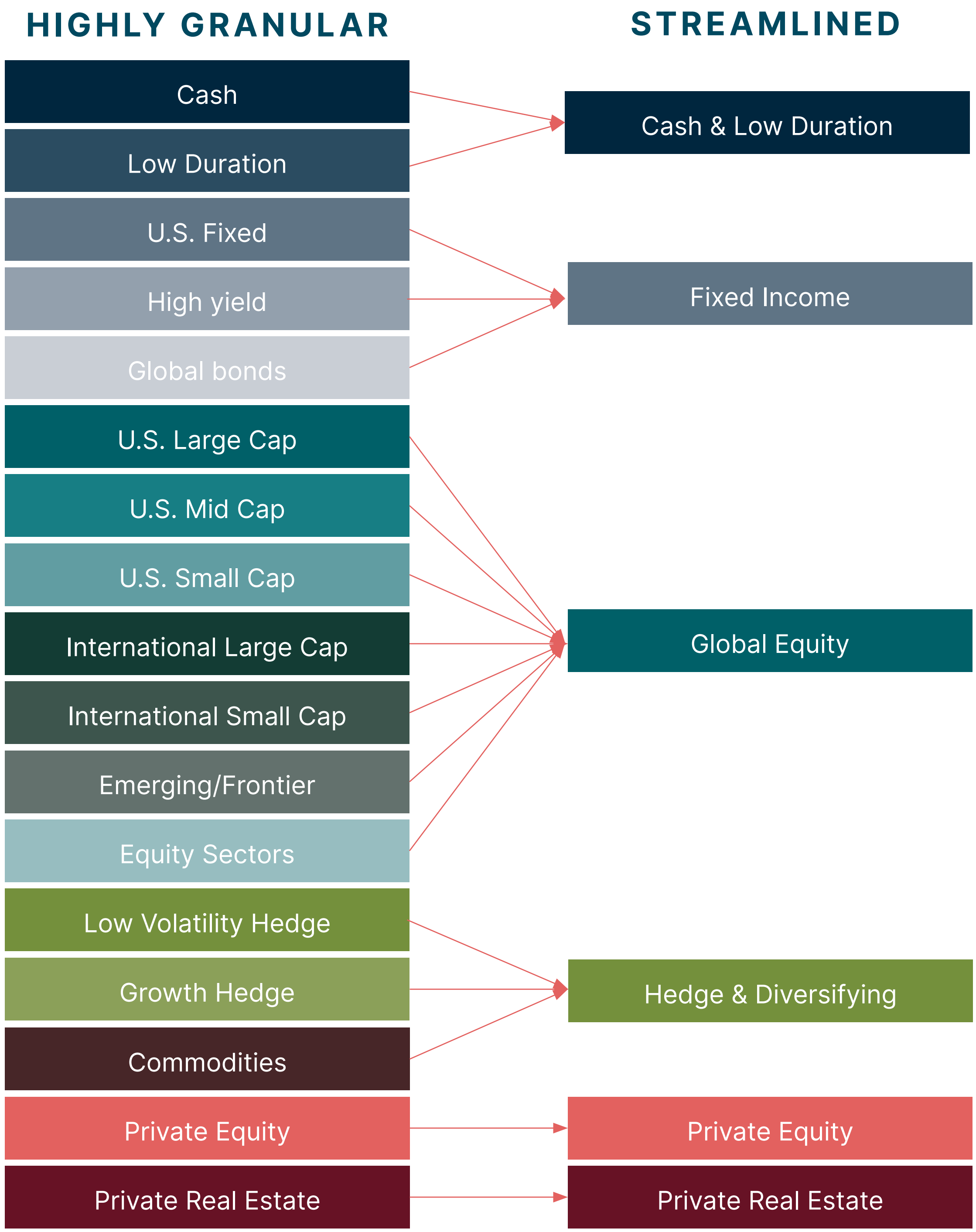
Figure 1: How many truly different asset classes do you see in this picture? Two: stocks and bonds.



As Figure 1 illustrates, in reviewing the broad universe of investable asset classes, it's clear that while there are a multitude of highly granular asset classes to choose from, many have not historically provided meaningful diversification from one another.

To address and solve for this issue, we think it's best to combine similar asset classes (Figure 2) and develop a more streamlined list of six more broadly defined asset classes that are more meaningfully differentiated and capable of providing better diversification.

Figure 2: Developing a more optimal asset class structure



Our six broad asset classes are defined as follows:

1. **Cash and Low Duration:** Includes transactional cash, money markets, ultrashort, and low duration domestic-focused investment grade fixed income with duration up to three years.

2. **Fixed Income:** Includes all publicly traded fixed income, across all regions, sectors, and credit. Examples include government, corporate, municipal, high yield, emerging market, and international bond funds and securities.

3. **Global Equity:** Includes all publicly traded equity, across all regions, sectors, and size. Examples include U.S. large cap, mid cap, small cap, international large and small cap, emerging markets, frontier markets, and sector strategies.

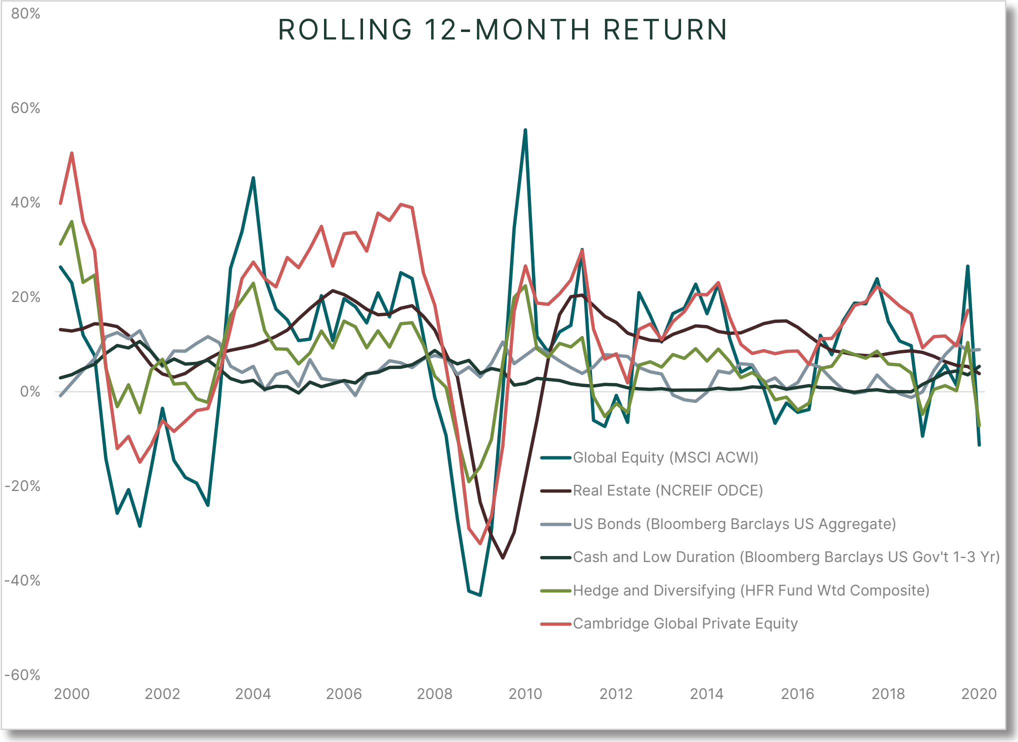
4. **Hedge and Diversifying:** Includes strategies with less than full equity-like risk exposure or correlation to equities, such as credit, hedged equity, balanced funds, global macro, special situations/opportunities, and commodities.

5. **Private Equity:** This includes investments in privately held companies or illiquid concentrated publicly held securities through funds or direct investment.

6. **Private Real Estate:** Includes investments in privately held real estate, either equity or debt, through funds or direct investment.

When we plot the historical performance of these six broadly-defined asset classes, we can see that they are highly differentiated in terms of return, volatility, and correlation to each other. With this set of asset classes as a foundation, we believe an investor can develop a well-diversified portfolio. (Figure 3).

Figure 3: Improved diversification with a more optimal asset class structure



Performance and Investment Policy Benefits

The more optimal asset class structure outlined in Figures 2 and 3 has two main features: the number of asset classes is limited, and each asset class is well-differentiated by both performance characteristics (i.e., expected return, volatility, and correlation) as well as liquidity characteristics where possible. In addition to providing robust diversification, a streamlined structure with broadly defined asset classes, when incorporated in an investment policy statement (IPS), can provide the following benefits:

INCREASED ACCESS TO OPPORTUNITIES

- **Increases the investor's opportunity set.** This streamlined, broadly defined asset class structure allows the investor access to many types of strategies that would otherwise be excluded by a narrower structure. For example, under the narrow structure outlined in Figure 2, an investor would not have access to use a U.S. all-cap equity strategy, a global equity sector strategy, or a minimum volatility equity strategy. However, using a streamlined and more broadly defined structure, the investor can make use of these and many other types of strategies that might fall outside of traditional asset class categories, thus providing the investor with more opportunity to add value through manager selection.

- **Increases each manager's opportunity set.** By giving a manager the flexibility to access a broader range of investments, they have more opportunity to add value through security selection.

INVESTMENT POLICY BENEFITS

- **Reduces IPS complexity.** A streamlined asset class structure allows for a simpler, more compact, and manageable investment policy. This makes it easier for the investor or fiduciary to focus on what matters, while avoiding distracting redundancies and minutiae.

- **Makes the IPS more adaptable.** Generally, narrow asset classes evolve more rapidly than broad asset classes. Over time, new narrow asset classes will naturally be created, merged, or dissolved by market forces. For the investor with a highly-subdivided portfolio structure, the rise and fall of narrow asset classes will create additional policy maintenance burden over time. A broadly defined structure, on the other hand, will tend to be more adaptable and resilient to an evolving market.

Conclusion

While using a highly granular asset class structure can create the appearance of greater diversification, simply adding asset classes does not necessarily improve or increase actual diversification benefits. In fact, it may reduce diversification by limiting the opportunity set available to investors and managers. We therefore recommend that investors, in their quest for diversification, focus on enhancing portfolio diversification by using a concise lineup of truly differentiated asset classes. Such a streamlined structure provides a wide range of benefits to investors, such as increased access to opportunity, reduced complexity, and greater adaptability.

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