ADOBE STOCK

Building a portfolio is a lot like building a basketball team. Each player brings a different attribute.

The Diversification Game

A basketball analogy can help clients understand the benefits of investing across multiple asset classes.

By Craig L. Israelsen

Say you have a client who calls you, concerned, because her portfolio is not, at the moment, doing as well as the headline S&P 500 numbers she is seeing on the news.

It's up to you to illustrate how a diversified portfolio won't simply mimic the S&P 500, but can perform better over time, and with less volatility.

With your help, clients should come to understand why portfolios should branch out across multiple asset classes that ideally have low correlation with each other.

You can explain it like this: Building a portfolio is like putting together a basketball team. Each player brings a different skill or attribute to the team. It's the differences between the players — not the similarities — that help form the best lineup.

Thus, if a portfolio only includes the 500 large-cap U.S. stocks that comprise the S&P 500, isn't that kind of like building a basketball team by only having point guards, or only power forwards?

Those are not diversified basketball teams. Similarly, investing in the S&P 500 does not make for a diversified portfolio.

Now to provide a demonstration, which you can share with your clients.

In "Diversify Your Diversification," the starting point is a portfolio that only includes large-cap U.S. equities.

Over the past 20 years, the average annualized return was 5.62%, well below the historical norm of roughly 10%. But that was the reality from Jan. 1, 1999, to Dec. 31, 2018.

During this period, the S&P 500 produced positive annual returns 75% of the time. The index had a standard deviation of annual returns of 17.48%. Its worst calendar-year return was 37% in 2008, at the height of the financial crisis.

Over the past 20 years, the average annualized return of the S&P 500 was well below the historical norm.

Let's start building our portfolio team by adding some other ingredients to large-cap U.S. equities.

The result is an equally weighted four-asset portfolio that includes cash (90-day Treasury bills), U.S. bonds (Barclays Aggregate Bond Index) and small-cap U.S. stock (Russell 2000).

Each asset class is given a 25% allocation and rebalanced annually. With this portfolio, the 20-year return does decline slightly to 5.34%, but the portfolio volatility (as measured by standard deviation of return) plummets to 8.68%.

This means volatility was cut in half. Positive annual returns occurred 80% of the time, and the worst one-year loss was only 16.04%, compared to 37% if only invested in large-cap U.S. stock. Overall, this is an endorsement for adding more ingredients to a portfolio.

But we need not stop there. We will now add some diversifiers to our portfolio team. The first is non-U.S. stock (MSCI EAFE Index).

Each asset class now has

a 20% allocation and is rebalanced every year.

As shown in the table, 20-year performance declined slightly to 5.14% and standard deviation ticked up from 8.68% to 10.94%.

The percentage of positive annual returns fell to 65%, and the worst one-year loss increased to 21.51%. Foreign equities have been a party pooper asset class over this time.

If we added REITs (Dow Jones US Select REIT Index) as the diversifier asset class instead of foreign equities, the results were much better.

The 20-year average annualized return for the five-asset portfolio jumped to 6.43%, or 81 bps higher than the S&P 500 by itself.

Even better, the added return was achieved with 44% lower volatility.

Adding commodities (represented here by the S&P Goldman Sachs Commodity Index) as the 5th asset diversifier hurt performance (4.89% 20-year return) but actually lowered the standard deviation of return more than when we added foreign stock.

What happens if we equally weight all seven asset classes? The 20-year performance is 5.67%, or 5 bps higher than the S&P 500 alone.

This is rather amazing, inasmuch as the seven-asset portfolio had an overall asset allocation of 71% to equities and diversifiers, and 29% to fixed income. Yet it outperformed 100% equity.

Plus, it achieved that slight outperformance while reducing volatility by 33%. Positive annual returns were achieved 75% of the time, and the worst calendar-year loss was 27.6%. The past 20 years paint a very supportive picture for broad portfolio diversification. How about over the past

Diversify Your Diversification

Equally Weighted Portfolios Equal allocation to each asset class with annual rebalancing, 20-year period from 1999 to 2018	20-Year Annualized Return (%)	20-Year Standard Deviation of Annual Returns (%)	Percentage of Years With a Positive Return	Worst Calendar-Year Return
100% U.S. Large-Cap Stock	5.62	17.48	75%	-37%
Now Build a 4-Asset Portfolio **25% allocation to each asset with annual rebalancing**				
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock	5.34	8.68	80%	-16.04
Now Add a Diversifier **20% allocation to each asset with annual rebalancing**				
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock **Add Non-U.S. Stock**	5.14	10.94	65%	-21.51
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock **Add REITs**	6.43	9.82	80%	-20.67
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock **Add Commodities**	4.89	10.09	75%	-22.13
Now Blend All 7 Assets Together **14.28% allocation to each asset with annual rebalancing**				
U.S. Cash, U.S. Bonds U.S. Large-Cap Stock, U.S. Small-Cap Stock Add Non-U.S. Stock, REITs and Commodities	5.67	11.65	75%	-27.6

Source: Steele Mutual Fund Expert; calculations by author

49 years (from 1970-2018)?

Since 1970, the S&P 500 produced a 49-year average annualized return of 10.21%, had a standard deviation of 16.98% and generated positive annual returns 80% of the time.

The equally weighted four-asset portfolio consisting of cash, U.S. bonds, large-cap U.S. stock and small-cap U.S. stock had a 49-year return of 8.75% and a standard deviation of 9.63%. It produced positive annual returns 86% of the time.

If we add foreign stock as the 5th asset class, the return is 8.90%, the standard deviation 10.93%, and positive annual returns were generated 78% of the time.

Real estate produced a 49-year portfolio return of 9.45%, a standard deviation of 10.42% and 84% positive annual returns.

Commodities as the 5th asset class generated a portfolio return of 8.86% and a standard deviation of 9.04%, and positive returns 88% of the time.

Interestingly, commodities — while not enhancing performance — did the best job of lowering volatility and producing positive annual returns. This is due to the low correlation between commodities and the other assets..

Finally, if we combined all seven asset classes into an equally weighted portfolio (14.28% allocation to each asset), the 49-year return was 9.48%, the standard deviation was 10.23% and there were positive returns 86% of the time. The performance of the seven-asset portfolio was slightly lower than the S&P 500 (by 73 bps), but volatility was reduced by nearly 40%. Additionally, the multi-asset portfolio produced positive annual returns more often (86% to 80%).

The key takeaway: Clients should understand that diversification across multiple asset classes is just as important as diversification within each asset class. Here's to enjoying the upcoming basketball season. **FP**

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Is It Europe's Time to Shine?

If clients' portfolios need international diversity with a focus on dividends, these three funds may be worth consideration.

By Joseph Lisanti

The MSCI Europe Index rose a hefty 14.46% in the first six months of 2019, but performance in the second half of last year was dismal.

As a result, over the 12 months that ended in June, the index gained a measly 0.13%.

But after a decade of U.S. stock outperformance, it might just be Europe's big moment.

Markets are expecting a rate cut from the European Central Bank, which could help boost the region's stocks. Equity valuations are modest and yields are attractive.

It should be noted, however, that some potential clouds are on the horizon, including the U.K.'s headlong rush into a no-deal Brexit in October.

If you believe your clients' portfolios need a bit of European dividend seasoning, here are three ETFs that focus on the region.

Markets are expecting a rate cut from the European Central Bank, which could help boost the region's stocks.

Note: We have eliminated currency-hedged funds as well as those that concentrate on a particular capitalization size or yield level.

Each of the following takes a broad view of European stocks.

O'Shares FTSE Europe Quality Dividend ETF

(OEUR, expense ratio: 0.48%) holds stocks of more than 150 dividend-paying European companies. The fund, which was launched in August 2015, owns equities that meet certain capitalization, liquidity, quality, volatility and yield criteria established by index provider FTSE Russell.

Weighting is factor based. At the end of June (the fund's most recent report of country and sector positions), OEUR's heaviest country bets were in the United Kingdom (29.26%), Switzerland (20.14%) and France (15.91%).

Health care was the largest sector