



Diversification is Not Enough

Traditional methods of diversification fall short on risk management.

By Roger J. Schreiner

December 29, 2009

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

Investors have had some interesting things to say during the ongoing financial crisis. “My previous advisor had me well diversified,” several new clients have told us, “but my portfolio still lost almost forty percent of its value.” Unfortunately, during a systemic breakdown like the global financial crisis, diversification is not enough to insulate investors from heavy losses.

In the future world of slower growth and lower returns, “There are three things that every investor needs to get right,” said Mohamed El-Erian, co-CEO of PIMCO, in a recent interview with Jason Stipp of Morningstar. “The first thing is a forward-looking asset allocation—not a backward-looking asset allocation, but an asset allocation that makes sense in ‘The New Normal.’ Secondly, finding the vehicles that are stable enough to express that allocation. And, thirdly, risk-management.”

El-Erian said it is not enough to be diversified. Diversification is absolutely necessary, but it’s not sufficient. He believes investors must look at other elements of risk management in order to navigate in times of lower returns and potentially higher volatility.

The mainstream financial services industry, the media and academia—virtually everyone—has overestimated the value of diversification in risk management. The recent crisis has shown that investors need more than simple diversification to protect them from both the known and the unknown risk that they will eventually encounter. When it comes to risk management, diversification simply is not enough.

Who’s watching the kids?

There are three basic types of risk to a stock investor’s portfolio:

1. Company Risk: the risk that a specific company will have a problem
2. Sector Risk: the risk that an industry sector will have a problem
3. Market Risk: the risk that the overall market will have a problem



Diversification is an obvious way to attempt to mitigate these risks. But, ironically, if you ask an investor on the street, “Who manages the risk in your mutual funds?” they will probably tell you, “The fund manager.” Ask the fund manager what his job is and he will tell you, “I’m paid to pick stocks. Risk management is handled at the portfolio level, not the fund level.” The irony is that each party thinks the other is doing the risk management, but neither actually is.

Mutual fund managers are evaluated by how well they perform versus their benchmark. The S&P 500 fell over 56% during the recent crisis, so if your large-cap mutual fund lost 50%, according to conventional thinking, you owned a great fund. If you were really lucky, maybe you were invested with Morningstar’s Domestic-Stock Manager of the Year for 2008. Charlie Dreifus, who manages the Royce Special Equity Mutual Fund, kept his losses to 40.5% between October 9, 2007 and March 9, 2009 while his benchmark, the S&P 500, tumbled 56.8%. During the worst of the crisis, even “the best” mutual fund managers in America suffered huge losses.

The idea that a 40% or 50% loss can be considered “good” makes no sense to me. The fact that it does make sense to the mainstream investment community is mind-boggling. A loss of that magnitude would be a disaster to every investor I know. This kind of loss puts the investor in a hole so deep that it can take a decade or more to recover.

It is important to appreciate the fact that diversification does an excellent job reducing company risk and sector risk. The risk of holding a diversified sector fund is significantly less than the risk of holding stock in an individual company. Likewise, a mutual fund representing the broader stock market is far less risky than a fund focused on a single industry sector. When it comes to managing market risk, however, diversification falls painfully short.

When there is a systemic problem affecting the entire market—the recent global financial crisis is a perfect example—diversification can be worthless. It’s like bringing a knife to a gun fight.

No place to hide

In any discussion about the financial crisis and its affect on investors, you can be sure that someone will lament, “Everyone got killed. There was no place to hide.” What they really should be saying is, “My investment process was inadequate. I had no place to hide because I was not prepared for this kind of systemic risk.”

There *were* places to hide during the crisis. Cash performed well and so did bonds. Investment techniques such as hedging and shorting also helped investors. Gold and other precious metals, while not completely immune, performed well during the fourth quarter of 2008 and first quarter of 2009 as stocks fell another 30%.



Students of market history understood the potential for systemic failure. They know that financial crises happen. Markets have crashed before and that they will crash again (no matter what politicians say). Such is the nature of cycles.

Successful investors understand cycles and plan for unknown and unexpected events, while average investors suffer from average thinking and crowd behavior. Average investors were not prepared for the recent financial crisis, and they will be ill prepared for the next one. It makes sense that they think there was no place to hide. Successful investors, on the other hand, may not have foreseen the crisis, but they were prepared for it. Their investment process included cash, alternatives and crisis-avoidance techniques. Their planning was grounded in economic and market history.

Limiting exposure to manage systemic risk

Assume that you and I are both above-average drivers and we want to see who's more likely to crash first. All things equal, it's a coin flip. But what if I had to drive my car for twelve hours, while you only had to drive yours for eight hours each day? Which one of us is more likely to crash? I am, of course.

The stock market is no different. The more time one is invested, the more likely they are to experience a crash. The biggest factor in determining investment risk is exposure. Avoid exposure and you avoid most of the risk. Avoid most of the risk and you avoid most of the potential for loss.

Mutual fund managers are right about one thing: Risk management is handled at the portfolio level, not the fund level. It is the responsibility of the investor and their advisor to select when to expose themselves to risk and how much of their portfolio to shield from it.

Roger Schreiner is the founder and CEO of Schreiner Capital Management, Inc. (SCM), an SEC-registered investment advisor located in Exton, Pennsylvania. SCM is a third party investment manager and sponsors the Select Advisors Wrap Program, an investment platform that provides active investment solutions for Advisors and their clients.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>