Over the long term, diversification still wins

Since 2009, US equities have outperformed every major asset class by a considerable margin, returning 14.5% a year on average. And, over the same period, a simple 70% US equity/30% bond portfolio[1] returned 11.4% per year, on average.

These kinds of results can tempt even the savviest investors into abandoning their long-term discipline and chasing returns. Indeed, many investors have recently raised the notion of whether to just invest 100% in US equities, or in a simple, indexed 70/30 portfolio.

Similar to today, many investors asked the same questions about the diversified approach in the late 1990s. From 1995 through 1999, there was also a sustained bull market, and a simple portfolio outperformed a diversified one for an extended period of time. But there was a key difference between US equities' outperformance then compared with today: portfolios' starting positioning. In 1999, endowments allocated an average of 45% to US equities. Today the average allocation to long-only US equities is just 20%, which could make the feeling of missing out seem even greater.

But with history as a guide, diversified portfolios still prevail over the long term. Last year's research report, "The 15% Frontier," suggests that, on average, investors with more than 15% in private investments were consistently top-quartile performers over the long term. In fact, if those investors with highly diversified portfolios had abandoned that approach during the bull market of the 1990s, they would have earned lower long-term returns and have smaller portfolios today as a result.

Even with two historic bull markets and indexed portfolios outperforming diversified portfolios in 12 of the last 20 years, *these long-term investors have more money today because they stayed with the long-term, highly diversified portfolio approach*.

Over the 20 years ending June 30, 2016, a simple US stock/bond portfolio returned 7.6% annually. A globally invested indexed portfolio fared worse, returning 6.0% annually during the timeframe. Assuming a typical spending rate of 5% and accounting for inflation at 2.1%, many investors would have been in danger of not meeting their long-term objectives with an indexed portfolio.

Contrast that with a mean return of 8.6% annually, net of investment management fees, for the investors with highly diversified portfolios.[2] The diversified portfolio bested US and globally invested index portfolios by 100 basis points and 260 basis points, respectively, over the full time period.

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[1] US equities represented by S&P 500 Index; bonds represented by Bloomberg Barclays Aggregate Bond Index.
[2] Includes institutions with an average annual allocation to private investments of at least 15% over the time horizon. Private investments include private equity, venture capital, private distressed securities, private real estate, private oil & gas/natural resources, and timber.

That outperformance provided highly diversified investors with more money to spend—and larger assets even after spending. Assuming an annual spending rate of 5%, a $100 million portfolio that experienced the highly diversified investors' mean annualized return over the 20-year time period would have spent a total of $143 million over the time period; indexed US and global portfolios would have only spent $133 million and $103 million, respectively. Even after accounting for spending, the highly diversified portfolio would have a market value of $187 million today while the simple, indexed US and global portfolios would be worth just $155 million and $115 million, respectively.

There are of course realities and considerations that the best investors must, and do, take into account. First, while the sustained outperformance of US equities since 2009 is rare, it is not unheard of. Investors should assume that a simple portfolio will outperform a diversified one at various points in the short term, despite diversified portfolios having higher expected long-term returns. And they must be prepared to persevere when their portfolio returns are lagging in the short run.

The other consideration—a very important one—is the degree to which private equity, venture capital, hedge funds, and other strategies in a highly diversified portfolio might deliver on the expectations investors have for them. Clearly investors who were early adopters of alternative assets reaped huge premiums for taking a chance on new investment strategies. These markets have matured since the 1990s, when annual return expectations for private investments were in the high-teens to low-20s and hedge funds were returning in the mid-teens. More recently, private investment returns have been closer the mid-teens range and returns for hedge funds (in excess of cash) have peaked in the high single digits over rolling five-year periods.

But even as return expectations have come down, performance in these diversifying strategies remains highly dispersed, reflecting diff rences in both strategy and in manager skill. That dispersion reminds us that not all private investment and hedge fund strategies and managers are the same. Overall, there remain a meaningful number of quality investments in private equity and hedge funds that have an ability to add significant value to portfolios over the long term.

As the last 20 years have shown, alpha is available in every part of the market cycle, and investors who can find it significantly benefit from active management—even during beta-driven markets. And importantly, the likely reality is that the next decade's best performers will not be those that have loaded up on index equity beta and bonds. The appeal of indexed portfolios is based on recent performance that is unlikely to be repeated over the next decade. While timing is anyone's guess, valuations for global stocks and bonds are currently so elevated, long-term investors would be hard pressed to find ways for an inexpensive, indexed portfolio to meet their long-term return objectives over time.

When the market inevitably corrects itself, the investors most likely to meet their return objectives are those who continue to embrace diversification and can generate alpha. The savviest investors know that the best way to do that is to avoid making short-term decisions that take them away from opportunities at precisely the wrong time.