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Harman Wealth Market Bulletin

The Mistaken Path to Detractive Diversification

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At Harman, we maintain high standards for selecting investments and contend that naïve additions of new assets classes in the name of diversification can be faulty. While some newly promoted investment ideas can be timely and useful, they clearly don't deserve a permanent place in the asset allocation lineup.

Since the Global Financial Crisis of 2008, investment thought leaders have advocated the notion that traditional stock-bond models of asset allocation were outdated and broken. Instead, investors needed a heavy emphasis on globalization and widespread adoption of newer "alternative" asset classes into the conventional core.

Going forward, the new message was that the world had changed, and new ways of investing were necessary. Beyond a mix of large, small, and foreign stocks, what investors really needed was something else. Intelligent asset allocation would require a larger exposure to the emerging markets plus a dedicated sleeve of real asset stocks, based on oil, commodities, and precious metals. Additionally, investors needed a complex mix of alternative hedge fund strategies.

Detractive Diversification

How have things fared since the widespread adoption of these new asset classes?

Well, it seems that none of these new "necessary" categories have delivered very well. Emerging market stocks are barely above highs from 2011. Gold and commodities are down more than thirty to forty percent from the same time.[1] Energy and pipeline stocks are negative compared to five years ago.[2] Meanwhile, a broad market index holding U.S. large cap stocks delivered three-year and five-year annualized returns in the low teens.

The returns of alternatives have likewise been dismal. Less than 7% of funds classified as an "alternative" in Morningstar with a five-year history returned more than 5% on both 3-year and 5-year measurements.[3] To make matters worse, many funds that were in operation five year ago have since closed due to poor performance.

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How did the experts get it so wrong?

Upon examination, it's clear the experts could hardly have fared worse with their recommendation on intelligent portfolio management. What appeared to be prudent advice then, now looks severely misguided. So, how could they have missed so badly?

For each new alternative asset class, the explanations vary and can be complex. However, the investment industry does deserve collective culpability for the naïve and faulty reasoning behind their push.

Issue #1: Missing the "Why?"

Sound investments are more than just surface level numbers on a page. In some form or fashion, they harvest return sources to produce a positive outcome. For example, stocks harvest growth and profits, while bonds harvest yield. Behind every investment everywhere there is a fundamental "why" behind the rate of return.

To understand an investment, one must get below the surface and reach second order thinking. One must understand and get to the "why" it performs well or poorly and when it may do so.

After the Great Financial Crises of 2008, it seems the industry forgot this. Instead, the industry fell victim to one of the oldest and most common mistakes of investing: return-chasing behavior. It created and promoted massive amounts of product based on what had just done well without asking for the "why." Regrettably, the consequence of stopping at the first level led to promoting a new form of diversified portfolio investing just when the winds of performance were changing.

Issue #2: Failure to ask what would happen if circumstances changed?

In the world of investing, there is no such thing as an investment that does well in all circumstances. Instead, each type of investment is dependent upon specific, unique, and temporary circumstances.

In the wake of the Great Recession, the global macro conditions assisting these newly promoted alternatives abruptly shifted. Political risk in Europe and Japan was amplified while demographics and debt ratios deteriorated. China's phenomenal "growth" story became a "slowdown" story, changing the economic landscape for commodity-exporting countries and emerging market nations across the globe. Furthermore, low interest rates and overcrowding in hedge fund-like strategies contributed to substandard performance.

What does it all mean for investors?

Let's not be mistaken. Diversification is an essential practice for the success of a long-term portfolio. Prudence demands diversifying one's risk exposures. In response, the Harman Wealth team actively manages across a range of risk exposures on behalf of our investing clients.

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Furthermore, not every new asset class deserves a permanent seat at the table. Understand that many investment categories are driven by cyclical and temporary forces, becoming very useful only when the timing is right. But, they should also be relegated to the specialist role, being called upon only when conditions align in their favor.

Since investors don't get the opportunity for a do-over, the recent lesson of detractive diversification should be taken to heart. Attempts to redefine portfolio management should have been met with a higher burden of proof. Moreover, attempting to pick the most useful investments for the next ten years today is naïve and fool-hardy.

For the future, we all must realize that progress in portfolio management most likely won't come from some new "buy and hold" asset class. Instead, progress starts with a deeper understanding what truly drives returns across different investments while building in adaptability and responsiveness for when conditions change.

Sources:

[1] Morningstar
[2] Stockcharts.com
[3] Morningstar

Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. Likewise, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing, we invest consistent with business cycle forces. We aim to align investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

Disclosures:

It is our goal to help investors by identifying changing market conditions. However, investors should be aware that no financial advisor can accurately predict all of the changes that may occur in the market. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed.

Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when coordinated with individual professional advice.

The Standard and Poor's 500 is an unmanaged index generally representative of the U.S. stock market and cannot be invested in directly.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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