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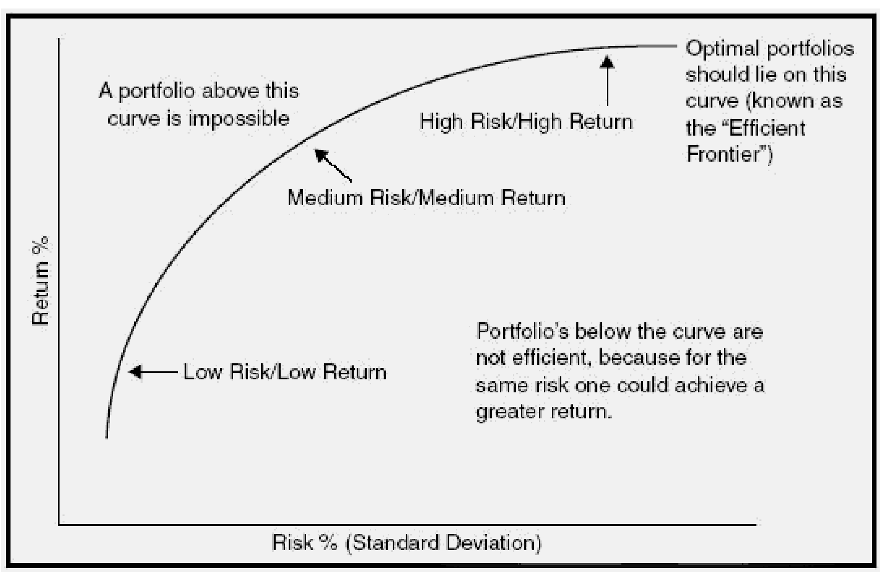
WHY PORTFOLIO DIVERSIFICATION ISN'T DEAD IN THE LEAST

It is sometimes easy for investors to lose track of the big picture while focusing on the details. Few spend as much time worrying about their portfolio diversification and asset allocation as they do looking for winning investments. After all, gains and losses are made with stocks and funds, not abstract portfolio concepts. But while the performance of each of your holdings is important, the overall performance of your portfolio is all that matters in the long-term. That's investing 101.

A key component of a well-performing portfolio has always been, and will continue to be, diversification between asset classes. In the last five years the effects of economic globalization have increased correlation between traditionally different assets and caused portfolio diversification to lose favor among many investors. But diversification remains a critical component of investing that has a direct influence on your portfolio's returns.

The Logic Behind Portfolio Diversification

Modern principles of portfolio diversification and asset allocation stem from Modern Portfolio Theory, formulated by Harry Markowitz in 1952. The theory explores the relationship between investment risk and investment return and defines the efficient frontier as the optimal combination between a particular level of risk and return.



A perfectly efficient portfolio delivers the maximum possible return for a given amount of risk. While it's very hard to quantify the efficiency of a portfolio, striving for the efficient frontier should be the goal of every investor. After all, why accept less than the potential return for your desired level of risk?

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Modern Portfolio Theory postulates that the key to achieving an efficient portfolio is diversification between non-correlated (or negatively-correlated) assets classes — broad categories of investments that share few similarities in their performance. Different scholarly publications suggest different asset mixes as optimal for achieving the efficient frontier. But their message is clear: diverse portfolios consisting of several non-correlated asset classes deliver more consistent returns with less volatility.

Recent Increases in Asset Correlation

The 2008–2009 recession in the United States and the ongoing European debt crisis have increased correlation between some asset classes. In the past, foreign developed and emerging equities provided good diversification to a portfolio of U.S. stocks. That is no longer the case. U.S. and foreign developed equities share a five-year correlation of around 93%, while U.S. and foreign emerging equities share a 91% correlation over the past five years. (Sources from Standard & Poor's)

Using market capitalization to diversify a portfolio isn't likely to be enough, either. In the U.S., the five-year correlation between large-cap and small-cap stocks has been around 95%, between large-cap and mid-cap (around 98%), and between mid-cap and small-cap (97%). (Sources from Standard & Poor's)

Similarly high correlations exist between growth and value investment flavors, as well as industries within a particular country. It is evident that while including a variety of equity holdings is a good place to start, it is not enough to sufficiently diversify your investment portfolio.

Asset Classes with Little Correlation

Fortunately, several asset classes continue to share little correlation with each other and can be great options for diversifying your portfolio.

The obvious choice to diversify an equity portfolio is through bonds. U.S. equities and bonds share a five-year correlation of only 17% — a trend which is likely to continue. Bond holdings can be especially useful to offset equity losses during prolonged bear markets. They are also effective at reducing overall portfolio risk as you approach the deadline for begging portfolio withdrawals (such as reaching retirement age).

More risk-cautious investors may choose to diversify their portfolios through cash holdings. Cash has virtually no correlation with other asset classes and the majority of cash investments are risk-free. However, their low risk is offset by their significantly lower returns, making cash appropriate only for the most conservative portfolios.

Another way to increase portfolio diversification is to invest in real estate. The correlation between the U.S. equity and real estate markets has increased to a five-year average of 83% since the 2008 real estate bubble. However, it is unclear whether this high level of correlation will continue. The correlation has been recently decreasing, with a one-year average now at 70%. It is possible that the correlation between equities and real estate will continue to decline to its more normal low levels. (Sources from Standard & Poor's)

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Diversified commodities or other alternative investments share a five-year correlation of around 55% with U.S. equities. This asset class presents another excellent opportunity for portfolio diversification. It should be noted that commodities or other alternative investments can be very volatile and risky. They are most suitable as a small satellite holding in a diversified portfolio.

Don't Lose Sight of the Big Picture

It takes time and thought to create an investment portfolio that will deliver consistent returns for years to come. After **setting investment goals** and **determining your risk tolerance**, you should focus on creating a diverse asset allocation. Portfolio diversification will allow you to maximize your returns while sheltering you and your wealth from unnecessary risk.

How diversified is your portfolio? Do you believe portfolio diversification plays an important role in determining long-term returns? At EisnerAmper Wealth Management, we are here to help to answer your questions.

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As always, information provided should be considered based on your personal needs to accomplish your goals. At EisnerAmper, we will be happy to discuss with you any questions and how these principals can be applied to meeting your financial plan. Feel free to contact Marc Scudillo, Managing Partner of EisnerAmper Wealth Management & Corporate Benefits, LLC; 908-429-0025 or email at mscudillo@eawmcb.com

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