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THE DIVERSIFICATION DILEMMA

Tactical Management and Today's Evolving Markets

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The Diversification Dilemma

How much diversification does a portfolio need? The short answer is, enough to sustain and withstand another Great Recession so that it can recover over the long term. Broad diversification across asset classes is the best defense against volatility or sustained downturn.

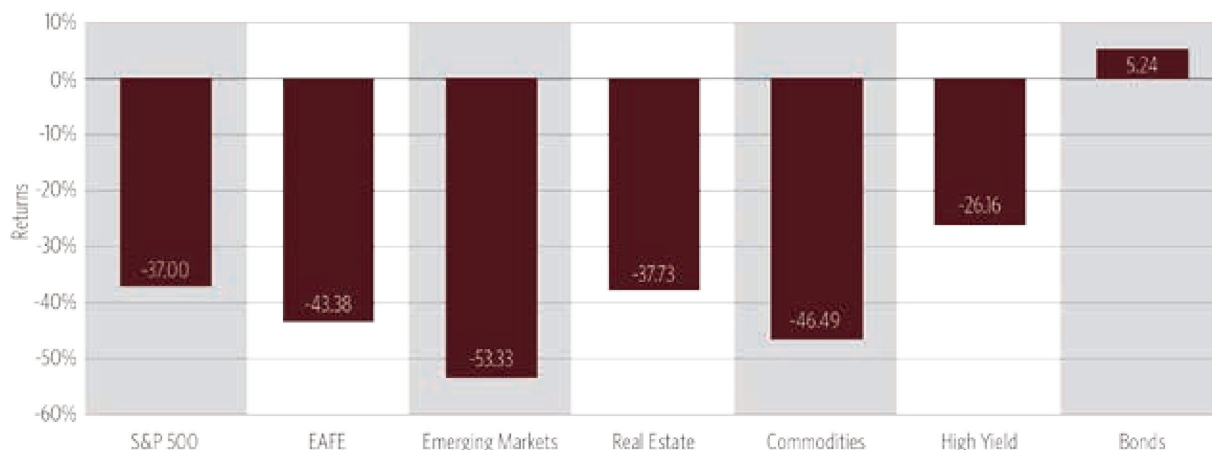
The Great Recession, which included 2008, taught investors this valuable lesson. When it was essential to be diversified, investor portfolios were often found lacking.

In looking at the chart below, we see that very few asset classes, other than high quality bonds, provided investors a shelter from the storm.

In this whitepaper, we will discuss portfolio diversification, the evolution of financial markets, and why we use the strategy of tactical portfolio management to help our clients invest wisely with the right amount of risk and opportunity.

During the Great Recession, there were very few places for investors to turn.

Exhibit 1: Asset Class Returns—Calendar Year 2008[1]



The Concept of Diversification

We've all heard the old adage "Don't put all your eggs in one basket." The underlying concept suggests that if the basket were to fall or break, so too would all of the eggs. But if there was more than one basket, the chances of the eggs breaking at the same time is greatly reduced.

Similarly, investors seek to diversify across multiple asset classes so they are protected when certain segments of the market take a downturn. The dilemma lies in scenarios like the Great Recession, when the majority of asset classes took a severe dip all at the same time, thus undermining the benefit of diversification. To understand the limits of diversification, it is important to understand what investors are trying to achieve by investing across multiple asset classes and the factors that determine asset class prices.

The most common point of discussion among investors when speaking on diversification is a divergence away from large-cap US equities. The S&P 500 Index includes the 500 largest companies in America and has become the bellweather for equity markets across the globe. When we turn on CNBC we cannot go one minute without knowing whether the S&P is up or down and what it means for investors.

Though it is tempting to discredit the tremendous focus on large-cap US equities, there is merit to why it's given so much attention. The bulk of portfolio risk is generally related to US equity volatility. Historically, at least 90% of a typical diversified portfolio's volatility can be explained by large-cap U.S. equities.[2] Logic would suggest that, to avoid this risk, diversifying away from it might be a wise choice. The thought behind it being, if the S&P is doing one thing, then other asset classes may be doing something different.

Achieving a well diversified portfolio by investing across multiple asset classes is what investors want, but it is important to understand what drives asset class prices before diving right in to revamping a portfolio.

The two largest factors that drives financial asset class prices are buyer and seller behavior. Put simply, if there are more buyers than sellers, prices will generally increase. Likewise, if there are more sellers than buyers, prices will generally decrease. In order to make educated decisions when determining how to diversify across asset classes one needs to be able to aniticipate buyer and seller behavior. It would be of no benefit for diversification to invest across five different asset classes whose investors are all likely to sell at the same time. Right?

In 2008 investors saw this play out in front of their eyes. As fearful investors sold out of all of their asset classes a slippery slope took over. The chance of a severe global economic downturn appeared imminent and investors not only sold out of the S&P 500--they sold all asset classes that they thought would be impacted. The funds from the "risky" asset classes that were most tied to the global economy were then invested in "safer" asset classes like bonds. The result of this type of buyer-seller behavior was that the price of equities was driven way down and the price of bonds was driven way up.

Since 2008 there has been some skepticism about whether or not diversification even works anymore. We believe that such an assertion is incorrect and comes from a lack of understanding of how diversification inherently works. The benefits of diversification are dervied from buyer and seller behavior and that behavior is subject to change. The evolution of markets includes adapting to change as buyers and sellers, but the foundation of sound portfolio structure, including diversification across asset classes should not change.

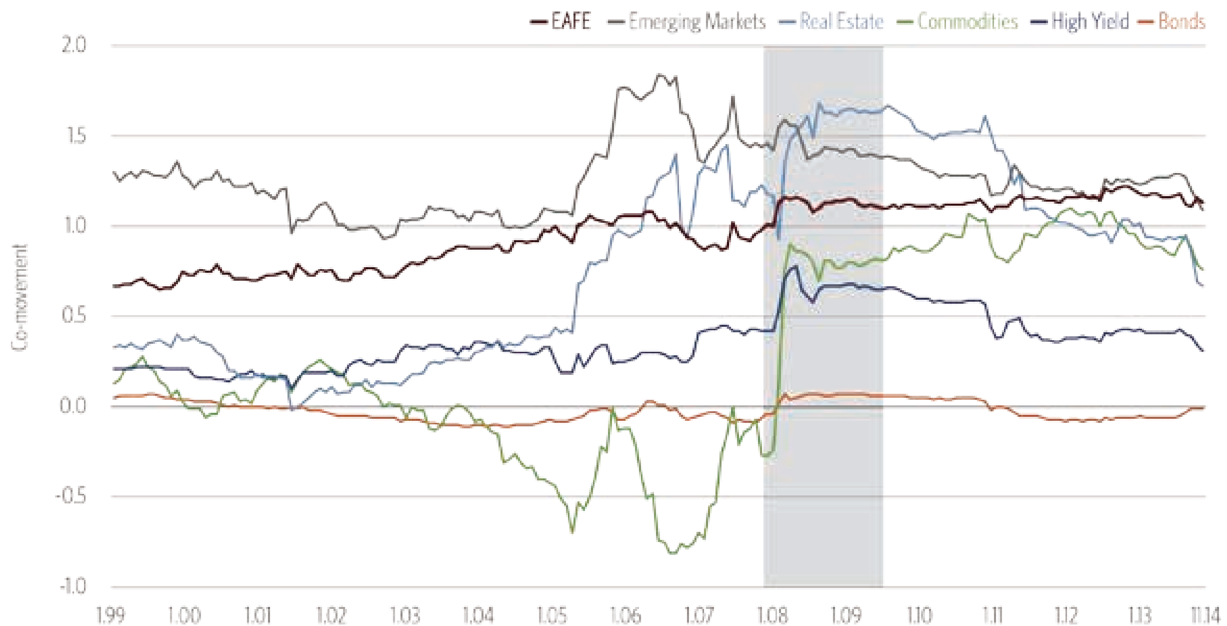
The Impact of Evolving Financial Markets

There are two major developments that have emerged in the last 20 years which have had a significant impact on asset class diversification. One is the increased integration of the global economy. The other is the innovation or "financialization" of financial products which has allowed buyers and sellers to behave uniformly across assets classes that are ties to the global economy.

Consequently, as the chart below illustrates, leading up to 2008 and continuing in the current environment, there has been increased co-movement between a broad range of "risk" asset classes and the S&P 500. Driven by buyer and seller behavior, these increases in co-movement significantly reduced the ability to diversify away the risk associated with the S&P 500, which dominates portfolios.

Increased Co-movement—The chart below illustrates the co-movement of assets to the S&P 500® Index. A measurement of 1 represents a high level of co-movement with the S&P 500; any measurement above 1 is indicative of leveraged comovement; and a measurement below 1 represents lower co-movement.

Exhibit 2: Co-movement of Assets to the S&P 500® Index[3]



High Quality Bonds?

Given low current interest rates, high quality bonds may not be an attractive source of return. For investors who need to see more than minimal investment returns, bonds may be safe but they aren't going to fund enough years after retirement. At the current levels bonds aren't outpacing the rate of inflation which means that, for investors who have not yet met their retirement funding goals, they are producing a net negative result. For these investors, it will be difficult to avoid exposure to "risk" asset classes, including below investment grade bonds. However, as we have discussed, we should not expect "risk" asset classes to provide high levels of diversification during stress periods, which is when diversification is needed most.

Although there is a high degree of protection with high quality bonds due to the distace they keep from playing a role in the global economy, they are not always the best bet for those who need to establish growth in their portfolio. There is always a place for fixed income in any portfolio and, as interest rates rise, bonds will become more attractive and they will always be a good source of diversification from the risk associated with the S&P 500.

The Importance of Tactical Asset Allocation

Given low interest rates and increased co-movement between "risk" asset classes and the S&P 500, balancing risk and return using traditional strategic asset allocation strategies has become more challenging than ever for investors. Tactical asset allocation provides hands on stratey that pays close attention to current market conditions and increases or decreases a portfolio's exposure to risk based on the current market climate. This is different than traditional strategic asset allocation which maintains static allocation in fixed income and equities regardless of what the markets are doing.

While each manager's approach may be different the tactic is to capture the return potential of "risk" assets including global equities, commodities, real estate and high yield bonds, while managing the risk associated with these asset classes. In essence, they seek to replace the reduced diversification benefit of allocating across multiple "risk" asset classes with modulation of market risk.

Summary

Achieving effective diversification across "risk" asset classes has become increasingly more difficuly for investors as the global economy becomes more integrated, financial products become more numerous and complex and as buyers and sellers respond to the evolution of the market in less rpedictable ways. The low yields of high quality bonds and the potential negative impact of rising interest rates are return headwinds for bonds. This reality creates a dilemma for investors needing more than minimal returns to reach their goals.

In response, investors should consider more tactical asset allocation strategies, which seek to replace the reduced diversification benefit of allocating across multiple "risk" asset classes with modulation of market risk.

At Andersen Wealth Management we believe one can only have true financial peace of mind when one knows without a doubt they have a comprehensive financial strategy designed to provide for them during the good times, and be defensive during the bad. At Andersen Wealth Management we also understand people need an ongoing advocate to guide and protect them through life's unexpected and inevitable turns.

As investment advisors representatives we work to help our clients avoid taking on unnecessary financial risks. Instead, we help our clients understand what their wealth represents to them: freedom, choices, stability, and a comfortable lifestyle and how they can make the choices that are best for themselves and their loved ones.

At Andersen Wealth Management we work with our client's to help them take control of their financial future through education and the creation of a comprehensive financial strategy.

Investment advisory services are offered through Michael Andersen Registered Investment Advisor, LLC d/b/a Andersen Wealth Management, a Maryland registered investment advisor. The firm only transacts business in states where it is properly registered, or is excluded or exempted from registration requirements. Registration is not an endorsement of the firm by the commission and does not mean that the advisor has attained a specific level of skill or ability.

The S&P 500 Index is an index of 500 stocks chosen for market size, liquidity, and industry grouping, among other factors. The index is viewed as a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S., and Canada.

The MSCI EM (Emerging Markets) Europe, Middle East and Africa Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of the emerging market countries of Europe, the Middle East, and Africa.

The FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property.

The S&P GSCI Index is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities.

The Barclays High Yield Index is a universe of fixed-rate, non-investment grade corporate debt of issuers in non-emerging market countries. Eurobonds and debt issues from countries designated as emerging markets are excluded.

The Barclays Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollardenominated, and non-convertible investment grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity.

Past performance is no guarantee of future results. Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

There can be no assurance that any investment product or strategy will achieve its investment objective(s). There are risks associated with investing, including the entire loss of principal invested.

Investing involves market risk. The investment return and principal value of any investment product will fluctuate with changes in market conditions.

The opinions and forecasts expressed may not actually come to pass. This information is provided for informational purposes only and is subject to change at any time based on market and other conditions, and should not be construed as a recommendation of any specific security or strategy.

For more information about our investment management solutions, please contact us today

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Notes

[1] Source: FactSet. **Performance displayed represents past performance, which is no guarantee of future results.** Index performance is for illustration purposes only and is not meant to represent any particular fund. Returns do not reflect any management fees, transaction costs, or expenses. The index is unmanaged and not available for direct investment. The S&P 500® Index represents the large-cap equity market. EAFE is represented by the MSCI EAFE Index. Emerging markets are represented by the MSCI EM Index. Real estate is represented by the FTSE NAREIT All Equity REITs Index. Commodities are represented by the S&P GSCI Index. High yield is represented by the Barclays High Yield Index. Bonds are represented by the Barclays Aggregate Bond Index. Please see p. 7 for index definitions.

[2] Source for calculation: Guggenheim Investments. Allocation comprised of 60% S&P 500® Index and 40% Barclays U.S. Treasury Index. **Past performance is no guarantee of future results.**

[3] Source: FactSet. **Performance displayed represents past performance, which is no guarantee of future results.** Index performance is for illustration purposes only and is not meant to represent any particular fund. Returns do not reflect any management fees, transaction costs, or expenses. The index is unmanaged and not available for direct investment. EAFE is represented by the MSCI EAFE Index. Emerging markets are represented by the MSCI EM Index. Real estate is represented by the FTSE NAREIT All Equity REITs Index. Commodities are represented by the S&P GSCI Index. High yield is represented by the Barclays High Yield Index. Bonds are represented by the Barclays Aggregate Bond Index. Please see p. 7 for index definitions.