Quick Clips: What's the Worst That Should Happen?

September 22, 2021

While expected returns on traditional assets are trending lower than their historical averages, the same is not true for the associated risks. Given this, setting investors' expectations may be more important today than ever.

Risk and return are central to investing. But while investors generally agree on how to define returns, risk is the subject of much disagreement, and as a result, often the source of forced selling when true risks do materialize. This study introduces a simple, intuitive definition of risk to help investors set expectations for their own portfolios: what's the worst I should expect to see over my investment horizon?

We show these "worst outcomes" for periods lasting one year up to five years and quantify how diversification can help mitigate them. Starting with traditional asset classes, we find stock/bond diversification tends to add value during these worst outcomes – especially over multi-year periods.

Good things come to those who wait (0:18)

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We also look beyond traditional assets by adding commodities to a stock/bond portfolio. Here again we discovered a consistent improvement to worst outcomes. Of practical importance to investors, we find a little can go a long way – e.g., diversifying even "half-way" can capture much of the benefits.

You don't need to be "perfectly" diversified (0:16)

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Many investors use alternatives to try to improve their overall portfolio's risk-adjusted returns. To investigate the role these strategies can play in risk reduction, we calculate the impact of reducing a portfolio's volatility, while maintaining its average returns. This is arguably a conservative goal for many alternative investors, and we show a meaningful benefit in expected worst outcomes.

The impact of adding alternatives to a diversified portfolio (0:20)

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While alternatives can reduce the length and depth of losses in many portfolios, investors' exposure to illiquid strategies may present more risk than meets the eye. Although illiquids may report lower volatility than their liquid counterparts, we find their true risk from a worst outcome perspective is larger than investors realize.

Risk considerations of illiquid assets (0:12)

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