ASSET ALLOCATION

The Death of Diversification Has Been Greatly Exaggerated

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Asset-class correlations generally tend to rise during crises. That certainly was true in the 2007–2009 financial crisis, and since then correlations have generally remained elevated as markets switch between binary risk-on/risk-off environments. However, we believe it would be wrong to interpret these developments as conclusive evidence of the death of diversification.

First, academics (Asness, Israelov and Liew [2011]) have stressed that while diversification often fails in short-term panics — especially one as systemic as the 2007–2009 crisis — it does effectively reduce downside risks over longer horizons. Second, high-quality bonds have fairly consistently provided positive returns during stressful market environments. Third, in this article, we argue and show that “factor diversification” has been more effective than asset-class diversification in general and, in particular, during crises. The last two arguments challenge the concentration in equity risk found in most institutional portfolios, which is also a central argument in favor of more risk-balanced, so-called risk parity, portfolios.

Traditional asset-class diversification involves allocating nominal dollars to various asset classes and their subsets. Several large institutions have begun to explore an alternative perspective of factor allocation, asking: What are the most important factors driving our portfolio returns? This perspective involves at least two changes. First, focus is shifted from dollar allocations to risk allocations. This change often reveals the dominant role of the most volatile asset classes and the portfolio’s dependence on equity market direction. Second, portfolio analysis is extended beyond asset classes to dynamic strategy styles or to underlying risk factors. Fundamental factors such as growth, inflation and liquidity are naturally interesting, but they are inherently hard to measure. Most investors prefer investable factors and therefore use market-based proxies — equities for growth, Treasuries for deflation and commodities for inflation.