From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Why Diversification Matters

Diversification is really a form of humility, in our view. The future is uncertain, which is why we diversify. At RiverFront, we seek to improve the basic principle of diversification by overweighting investments that our Price Matters® methodology indicates have a better long-term risk/reward outlook and underweighting those for which we believe the outlook is poor.

Diversification is NOT an assurance of higher returns, it is NOT a panacea. In our view, it is a belief that spreading your investments across different countries and asset classes reduces risk by smoothing returns. One way diversification does this is by allowing the positive performance of most of a portfolio's investments to dampen the effects of a few unique risk events in the portfolio. It is a time-tested investment principle in which we believe, especially if strategic rebalancing occurs.

Diversification can cause frustration when the 'home base' asset class is the outperformer, as has been the case for US investors during the last four years (see Weekly Chart) so let's remind ourselves of times when diversification helped investors.

Investors who had all their money in technology stocks in the late 1990s discovered the joy, and then the pain, of a concentrated portfolio. Japanese investors who have not diversified out of Japanese stocks in the last 30 years probably wish they had. We might want to remember that, in 1984, people were writing books about how Japan was going to dominate the world of business. Finally, investors whose life savings were in companies such as Enron, Fannie Mae, AIG, or Kodak now viscerally understand the benefit of diversification. Bottom line: concentrated portfolios are great when they work, but can be disastrous when they don't.

Diversification has its own emotional challenges. As soon as you own two investments, one of them is performing 'badly', or less well than the other one. The greatest emotional challenge comes when one investment performs consistently better than the others for a multi-year period. This is when the investor often questions the whole philosophy of diversification, abandons it, and jumps on the band wagon of the investment that is working. We see this most often when the successful investment is one's own country, sector, or company. Our recent observations have indicated that the outperformance by the US over the last four years is creating a frustration with diversification. Timing is hard, and momentum can work for a while, but in our experience abandoning a well thought out, diversified investment plan is often a decision that is later regretted.

Diversification is not an assurance of higher returns or a panacea. In short, it is really a form of humility. The future is uncertain, which is why we diversify.

At RiverFront we seek to improve the basic principle of diversification through our Price Matters® valuation yardstick – rebalancing from more expensive assets to cheaper ones.

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Renewed commitment to growth: Last Friday, two major central banks — the European Central Bank (ECB) and People's Bank of China (PBOC) — made moves to provide more monetary stimulus to their respective economies. When added to Japan's recent commitment to do the same, we see a significant shift in monetary policy outside the US, something we have been anticipating. It reinforces our view that this is the wrong time to be concentrating assets in the US. Last Friday, the euro fell 1.3% against the US dollar on the increase in expectations that the ECB will significantly expand its nascent quantitative easing program. With inflation so low in the Eurozone — currently just 0.4% year over year — and the region skirting recession, we think the ECB is well within its mandate to pursue greater monetary expansion. After spending most of this year providing 'targeted stimulus' to the economy, the PBOC finally decided to cut deposit rates 25 basis points (0.25 percentage points) to 2.75%. We view the PBOC's rate cuts in the context of further support from the Chinese government to ensure a soft landing as it adjusts to a major property slowdown and rebalances towards a more service-oriented economy.

THE WEEKLY CHART: RELATIVE PERFORMANCE GOES IN CYCLES

Source: *Thomson Reuters Datastream; past performance is no guarantee of future results.*

Our chart above shows that out- and underperformance by the US tends to go in cycles; it shows the relative performance of two broad cap-weighted indexes both created by Datastream. When the line is rising, the US is doing better, and vice versa. In the last 40 years, there is little evidence of sustained outperformance by the US; but the US has been outperforming since 2011, and is approaching its relative peak. From a momentum perspective, there is no sign of a change in direction, but our Price Matters® methodology shows that while US stocks have recovered to their long-term trend, developed international markets are still some 25% below trend; therefore we believe they offer better relative value.