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True Diversification is Hard to Achieve

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We often hear that investors need to have diversified portfolios to protect against market volatility. However, as many investors found out during the bear markets of 2000-2002 and 2007-2008, a traditionally-diversified portfolio does not provide much downside protection when the market crashes and takes everything down with it.

The traditional theory of diversification comes from modern portfolio theory. The idea is that if investors add non-correlated assets to their portfolio, they can increase returns and lower risk. While this is true in theory, in practice it is very hard to achieve. When most investors think about a diversified portfolio they think about large stocks, medium-sized stocks, small stocks, international stocks and bonds. A more advanced investor might also have allocations to hedge funds and private equity.

The problem with this approach is that during a market crisis most of these types of assets tend to fall at the same time. Diversification will give you some protection, as assets like bonds will probably not decline to the same extent as stocks; but how much comfort is it when the market is down 40% and your portfolio is only down 30%?

One of the main reasons that diversification does not provide a high level of protection is that, even though an investor might be giving money to managers who buy different types of stocks, the managers are still looking at the market in the same way. Whether a money manager buys large stocks, small stocks, medium-sized stocks, growth stocks, value stocks or international stocks, they are all looking for the same thing – stocks that are undervalued and poised to go up. In a down market there are an abundance of undervalued stocks, but they can stay undervalued for a long time.

The other big problem with traditional diversification is that there is no way for a diversified portfolio to make money in a steep market decline. When stocks are going down the best an investor can hope for is to not be down as much as the market.

Another way to look at diversification

A different way to look at diversification is to be diversified by the methodology used to select which in which markets to invest. For example, our portfolios currently consist of four models: one for the S&P 500 Index, one for the NASDAQ, one for energy stocks and one for 30-year Treasury bonds. Our models contain an absolute return component, as the S&P 500, NASDAQ and 30-year Treasury bond systems can go long or short, allowing them to make money in any environment.

The models are also completely different in what they look for to decide whether to long or short the market market, or to stay in cash. We use trend-following models and models that look for divergence. For example, during much of November 2008 our S&P 500 model was long while our NASDAQ model was short.

Trend-following

At any point in time a market can be doing one of three things – trending up, trending down or going sideways. A trend-following approach seeks to profit from uptrends and downtrends. For example, in the beginning of 2008 commodities and the euro were in a strong uptrend. Over the summer, these trends reversed. Investors who used a trend-following approach could have played these trends up and down.

Divergence

Many markets move in tandem; a move in one market can be predictive of moves in another market. For example, this year, when the US dollar has gone up, oil prices has trended down. Trading divergences involves finding these markets that are predictive and then entering trades when they diverge.

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For example, assume that Coca-Cola and Pepsi tend to move together and because Coke is bigger, moves in its stock tend to predict moves in Pepsi stock. You could watch this relationship and buy Pepsi when Coke goes up but Pepsi does not.

Because we use different types of models, there are times when our S&P 500 system might be long and our NASDAQ system might be short (or the other way around). Because each of our models uses different indicators and a different methodology, they are not correlated with each other, allowing us to obtain true diversification.

Matthew Tuttle is president of Tuttle Wealth Management, which specialises in designing innovative absolute return investment strategies.

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