Gravel Road Investing

Jim Parker, Dimensional Fund Advisors

Owners of all-purpose motor vehicles often appreciate their cars most when they leave smooth city freeways for rough gravel country roads. In investment, highly diversified portfolios can provide similar reassurance.

In blue skies and open highways, flimsy city sedans might cruise along just as well as sturdier sports utility vehicles. But the real test occurs when the road and weather conditions deteriorate.

That’s why people who travel through different terrains often invest in a SUV that can accommodate a range of environments, but without sacrificing too much in fuel economy, efficiency, and performance.

Structuring an appropriate portfolio involves similar decisions. You need an allocation that can withstand a range of investment climates while being mindful of fees and taxes.

When certain sectors or stocks are performing strongly, it can be tempting to chase returns in one area. But if the underlying conditions deteriorate, you can end up like a motorist with a flat on a desert road without a spare.

Likewise, when the market performs badly, the temptation might be to hunker down completely. But if the investment skies brighten and the roads improve, you can risk missing out on better returns elsewhere.

One common solution is to shift strategies according to the climate. But this is a tough, and potentially costly, challenge. It is the equivalent of keeping two cars in the garage when you only need one. You’re paying double the insurance, registration, and upkeep costs.

An alternative is to build a single diversified portfolio. That means spreading risk in a way that helps your portfolio capture what global markets have to offer while reducing unnecessary risks. In any one period, some parts of the portfolio will do well. Others will do poorly. You can’t predict which. But that is the point of diversification.
It is important to remember that you can never completely remove risk in any investment. Even a well-diversified portfolio is not bulletproof. We saw that in 2008–09, when there were broad losses in markets.

But you can still work to minimize risks you don’t need to take. These include unduly exposing your portfolio to the influences of individual stocks, sectors, or countries—or relying on the luck of the draw.

An example is those people who made big bets on technology stocks in the late 1990s. These concentrated bets might pay off for a little while, but it is hard to build a consistent strategy out of them. And those fads aren’t free. It’s hard to get your timing right, and it can be costly if you’re buying and selling in a hurry.

By contrast, owning a diversified portfolio is like having an all-weather, all-roads, fuel-efficient vehicle in your garage. This way you’re smoothing out some of the bumps in the road and taking out the guesswork.

Because you can never be sure which markets will outperform from year to year, diversification can help increase the consistency of the outcomes and help you capture what the global markets have to offer.

Add discipline and efficient implementation to the mix, and you may get a structured low-cost, tax-efficient solution.

Just as expert engineers can design fuel-efficient vehicles for all conditions, astute financial advisors know how to construct globally diversified portfolios to help you capture what the markets offer in an efficient way while reducing the influence of random forces.

There will be rough roads ahead, for sure. But with the right investment vehicle, the ride can be a more comfortable one.

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Another Perspective on Diversification

Our December 2014 and January and February 2015 issues of Asset Class presented index returns for a set of 17 asset classes ranked from highest to lowest each year since 1995.* The visual effect illustrates randomness (thus, the title “Yearly returns are random”). But what if you tracked an asset class’s ranking from year to year and compared it with that of others? We show this with U.S. large value and international large value stocks in the first two line charts below. The third chart shows them together.

You can see from this illustration the power of diversification. In some years when one asset class ranked high the other ranked much lower, and vice versa. For example, U.S. large value stocks were among the best performers in 1995, 1996, and 1997 when international large value stocks were near average or below. That changed in 1998 and 1999. And during the recovery from the “dot-com crash” (2003, 2004, 2005, and 2006), international large value stocks performed better on a relative basis. Over the past couple of years, the relationship reversed again.

The total return of international stocks has lagged U.S. stocks substantially over the past five years. However, investors would be wise to consider these observations before changing their long-term allocations away from international stocks as some experts, such as John Bogle, the former chairman of Vanguard, have suggested.

*Please note that these are not the returns of the asset classes but rather how they ranked each year among all 17 asset classes.