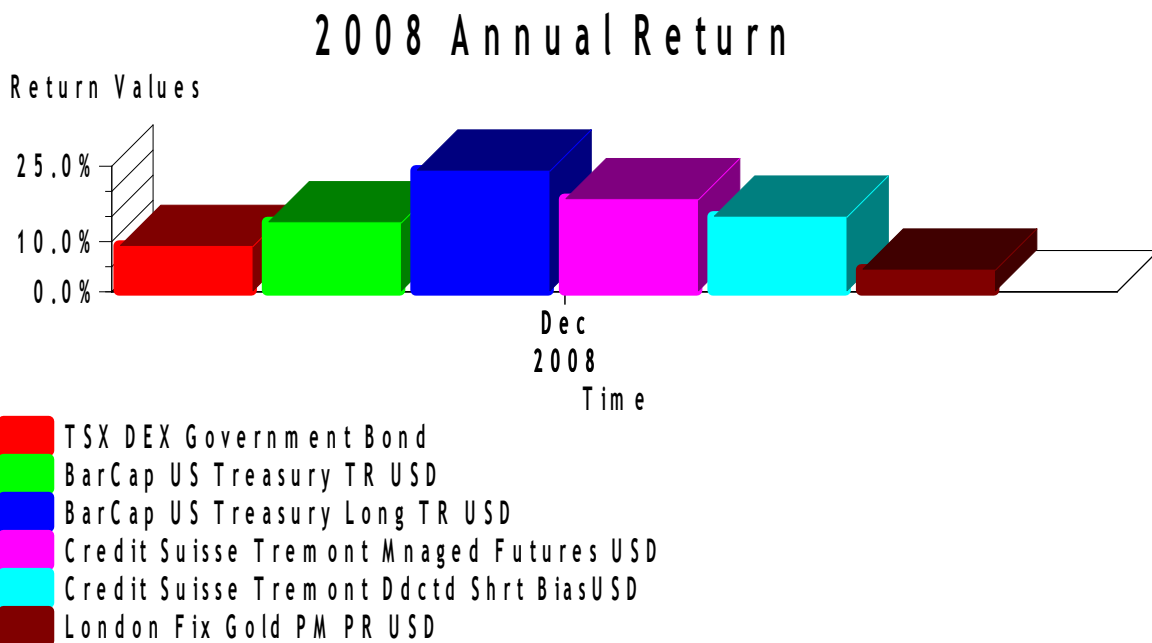




## The Discomfort of Diversification

When Harry Markowitz, an aspiring graduate student, had his article entitled Portfolio Selection published in the Journal of Finance in 1952, he could not have foreseen that his insight into diversification would earn him the Nobel Prize. His idea was simple but profound - “it is not enough to invest in many securities...it is necessary to avoid investing in securities with high covariances among themselves.”<sup>1</sup> Putting eggs in lots of different baskets isn’t enough; one has to select baskets which do not move in tandem.

Proper diversification blends asset classes and investment strategies that have low covariances meaning as some fall in value others will tend to rise. 2008 was a case in point. Although equities plummeted and corporate bonds faltered worldwide, a number of assets and investment strategies experienced positive performance as depicted in the following chart.

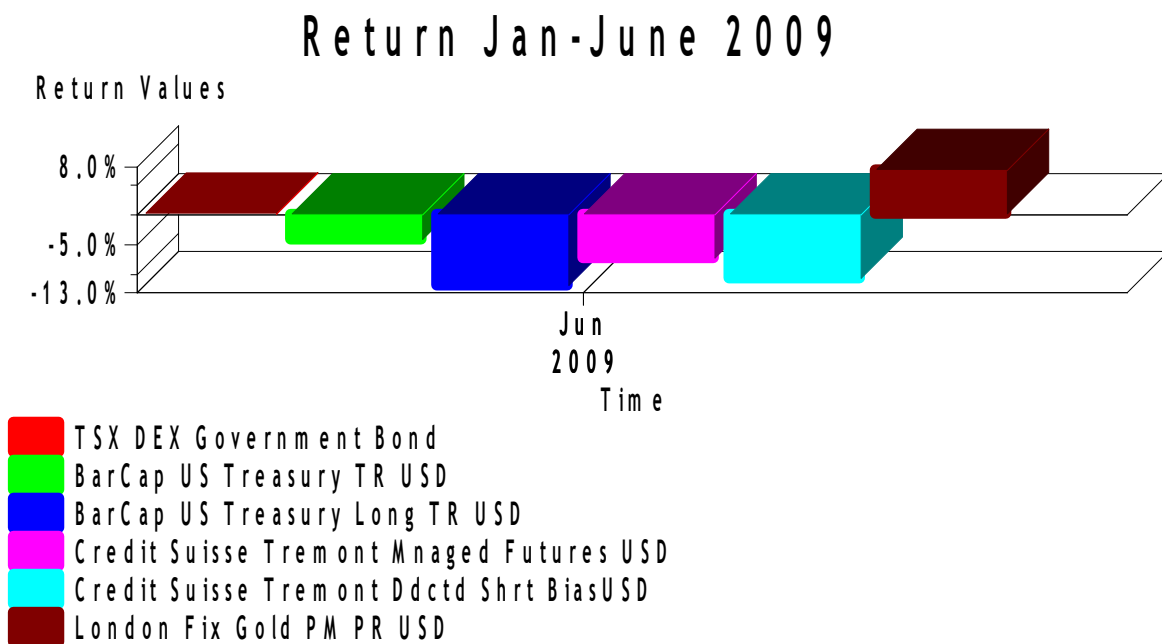


Government bonds, particularly longer maturities, managed futures and dedicated short hedge funds and gold all rose in response to falling interest rates, plunging stock prices, and the flight to the safe-haven of the U.S. dollar and precious metals. What these assets and strategies have in common are historically low or even negative



correlations to equities; in this light, their strong diversification effect in a year of epic stock losses should be no surprise. Investors with allocations suitable to their risk profiles were undoubtedly thankful.

Six months later, the investment landscape has changed. Stock markets have soared and, as evidenced in the following chart, with the exception of gold, last year's diversifiers are posting negligible or negative returns.



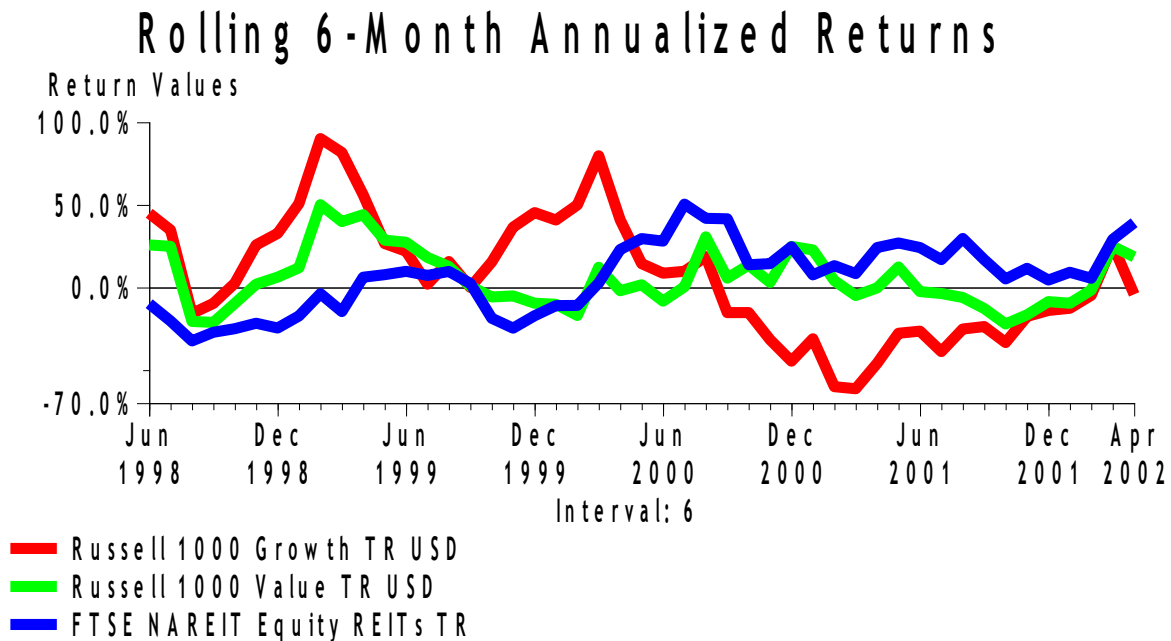
Yesterday's heroes have become today's losers. This experience typifies the veiled corollary of Markowitz's insight. Proper diversification is discomfoting - it entails constructing a portfolio with combinations of asset classes and strategies that will tend to fall in value when others tend to rise and vice-versa. In other words, having some portion of a portfolio invested in today's losers is an essential element of sound investment management.

Unfortunately, investors are ill-equipped to deal with this disappointing truth. Behavioural finance experts have found that investment decision-making is characteristically marred by cognitive errors including myopia - the tendency to be short-sighted; loss aversion - the predisposition to find losses much more painful than gains; and mental accounting - the tendency to categorize and evaluate economic outcomes in isolated groupings rather than as part of the whole. The result is that many investors react emotionally to any disappointing performance and impatiently



sell losers and chase winners, often at the most inopportune times. They forget that the essence of diversification demands a continual exposure to the losing asset classes of the day.

At times, diversification is not just discomforting; it is downright painful. When growth stocks soared in the late 1990's, many investors found the lagging returns of value stocks and REIT's intolerable. Yet, as illustrated in the following graph which compares the annualized rolling six-month returns of growth stocks (in red) to value stocks (in green) and REIT's (in blue), those laggards rapidly became winners as the tech crash pummelled growth stocks while value stocks and REIT's experienced, for the most part, positive returns.



Investors should know that although diversification works, it is discomforting because it inevitably entails having a portfolio allocation to losing asset classes and strategies. Winston Churchill once cleverly opined, "Democracy is the worst form of government, except for all those other forms that have been tried from time to time." To borrow his shrewd witticism, we can say that *diversification* is the worst form of *investing*, except for all those other forms that have been tried from time to time.

August 24, 2009

[www.tacitacapital.com](http://www.tacitacapital.com)



Tacita Capital Inc. (“Tacita”) is a private, independent family office and investment counselling firm that specializes in providing integrated wealth advisory and portfolio management services to families of affluence. We understand the challenges of affluence and apply the leading research and best practices of top financial academics and industry practitioners in assisting our clients reach their goals.

Tacita research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it and is not intended to replace individually tailored investment advice. The asset classes/securities/instruments/strategies discussed may not be suitable for all investors and certain investors may not be eligible to purchase or participate in some or all of them. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives. Tacita recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial advisor.

Tacita research is prepared for informational purposes. Neither the information nor any opinion expressed constitutes a solicitation by Tacita for the purchase or sale of any securities or financial products. This research is not intended to provide tax, legal, or accounting advice and readers are advised to seek out qualified professionals that provide advice on these issues for their individual circumstances.

Tacita research is based on public information. Tacita makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to inform any parties when opinions, estimates or information in Tacita research changes.

All investments involve risk including loss of principal. The value of and income from investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Management fees and expenses are associated with investing.

---

<sup>1</sup> Markowitz H., 1952, “Portfolio Selection”, *Journal of Finance*, Vol. 7, No.1, pp. 77-91.