

Diversification's Role as a Risk-Reduction Tool

An Interview With Richard Bernstein

Article Highlights

- It's not the number of assets that determines diversification; it's the correlation among them.
- Diversifying means buying asset classes you don't like in order to insure against your assumptions being wrong.
- The profit cycle is the driver of investment styles. When the profit cycle revs up, you want to take on more risk.

Richard Bernstein is the chief executive officer of Richard Bernstein Advisors LLC. We spoke recently about diversification and asset allocation.

—Charles Rotblut

Charles Rotblut (CR): You sub-advise a mutual fund that can vary widely in terms of its allocation to bonds and stocks. How do you determine what the right asset allocation is?

Richard Bernstein (BR): There are two mutual funds we run. Eaton Vance Richard Bernstein Equity Strategy fund (ERBAX) is a global equities fund, and we have great latitude in that we can go anywhere around the world. Eaton Vance Richard Bernstein All Asset Strategy fund (EARAX) is probably the one you are referring to: It is a global, go anywhere, all-asset fund.

How do we set the asset allocation? Well, I was at Merrill Lynch for over 20 years and one of the things we used to talk a lot about at Merrill was that people never understood diversification. They see charts and they are told that if they diversify their portfolio, they will get less risk and higher returns. What we always used to tell people is that diversification is not a return-enhancement tool; it is a risk-reduction tool. If you happen to get higher returns, then that's gravy; that's the icing on the cake. But really what diversification is all about is reducing the volatility of your portfolio. So that's one thing.

Number two is if that's the goal, then how do you reduce the volatility of your portfolio? Well, you have to look at the correlation among the asset classes. And it's not the number of asset classes that determines the diversification;



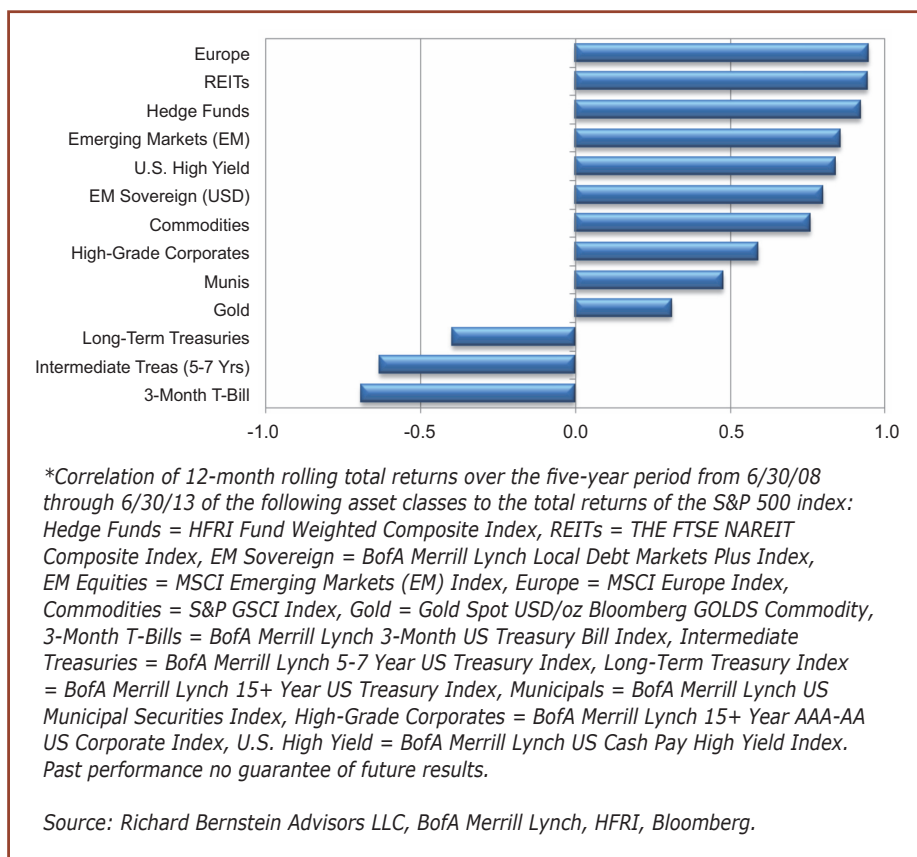
it's the correlation among those asset classes that determines diversification [Figure 1]. Somebody right now could say, well, I have U.S. stocks, non-U.S. stocks, corporate bonds, high-yield bonds, non-U.S. bonds, commodities, gold, private equity and hedge funds, but there is no diversification in the portfolio because those asset classes named are very highly correlated. So it's not the number of asset classes. You could technically form a very well-diversified portfolio with just two

asset classes if their correlations are negative.

What we like to do is to think of diversification as a seesaw. Some assets go up and some assets go down; the fulcrum of the seesaw is the volatility of your portfolio. So you have to try to figure out which side of the seesaw your assets are on. For a long time, you could actually balance out a portfolio by kind of an even number of asset classes. The problem today—and for the last five or six years—is that the seesaw has become very skewed. It is completely imbalanced. What is happening is that the correlation of all of these asset classes is going up. Really, the only asset class sitting on the other side of the seesaw is basically the Treasuries. What we do is try to find out the correlations in all of these different asset classes, how much risk and how we want to tilt that seesaw. That's kind of what we are doing.

The final point is: How do you measure the correlation? Honestly, you can make correlation say anything you want, depending on the time period you use. "I want to use daily data for three weeks," or "I want to use monthly data for five years." Basically you can make correlation say anything you

Figure 1. Historical 5-Year Correlation of Selected Asset Classes to the S&P 500*



want. If you are a commodity manager, you can show that commodities are negatively correlated—all you have to do is find the right time period. We look at what we call structural correlations. Structural correlations are the long-term trend in the correlation. So we are not looking at all the ups and downs. It's literally like watching paint dry. We can measure true underlying longer-term correlations, and they don't change very frequently. That's what we use and that's how seven years ago we began to notice that the seesaw was becoming very unstable. And I think people have learned that it has become very hard to diversify portfolios. That'll change, obviously. As those correlations change, we will change our portfolio.

CR: *What period of time do you consider to be long term?*

RB: We smooth out five years of data. The traditional calculation for beta was five years. It was originally thought

that five years incorporates the majority of the [market] cycle. If you start at the bottom and work your way up, it's going to look really good, and if you start at the top, it's going to look really bad. But five years is a pretty good time period because it includes most of a full cycle.

CR: *What about an individual investor who is trying to decide how to allocate his portfolio and doesn't have access to correlation data or simply isn't good at math?*

RB: It's a little bit difficult, which is why I think they need someone like us. Part of it is that they have to realize that diversifying among asset classes means buying things they don't like. Generally an individual investor will load up on assets that they think are attractive, again with this notion of getting higher returns and less risk. Well, you can't do that. That's not the way it works. You have to hold asset classes you don't like because diversification is all about insuring against your bets be-

ing wrong. If you think that these assets are all attractive, well, the opposite side looks very unappealing. If you're really going to diversify, you're going to have to hold something that is pretty distasteful. Case in point: The only diversifying asset class is Treasuries—think about how everybody hates Treasuries. There you go. That's a perfect example. So for individual investors, the first step in diversifying is realizing that you have to hold assets that you think are not going to work. And nobody wants to do that.

CR: *In terms of percentages, whether someone is working or retired, after looking at other asset classes versus Treasuries, do you have any suggestions on how to allocate?*

RB: That's difficult. For an individual investor to do it, it is difficult—that's why I'm not an individual financial planner. But within the context of a fund, we try to gear the risk so we will get similar returns to other all-asset funds, but hopefully with less risk. That's what we've been trying to do and—knock on wood—we have been successful. It is very difficult for an individual, but again the key thing is they have to realize that they have to hold assets that they think are not going to work.

CR: *What about rebalancing? If you still like certain asset classes in the mix, do you rebalance at some point?*

RB: Let's assume for a second that your reader has some sort of financial plan and has consulted a financial planner. Then yes, you do want to rebalance to the plan. Your tendency will be to say, well, the stock market is going up and stocks will be 70%, 80%, 90% of my portfolio; and you think, wow, this is great. Then all of a sudden we get a bear market, and you're thinking, oh, my 401(k) is destroyed. The important thing about rebalancing is not to rebalance by event, but to rebalance by time. What people often do is rebalance by some event, as when a bear market occurs and they rebalance. It's an emotional decision, and what we have always told people is you never want to invest based on an emotional decision. You want to do it by time, do it at the end of every

quarter or do it every six months. Pick a date in your calendar and circle it and that's the day you're going to rebalance. You're not going to rebalance in between.

CR: *What about yield? Yield, especially for our retired members, is a big issue—trying to get yield, while trying to balance safety in portfolio income.*

RB: Throughout my career, I was known to be a person who is very bullish on yield and thought it was very important. I was the one who came up with the statistic that since NASDAQ's inception in 1971, utility stocks have outperformed the NASDAQ composite. It shows you the power of compounding dividends. So the way I describe it is that if you can win an NBA championship shooting three-pointers or you can win an NBA championship shooting layups, why not shoot the layups? That field goal percentage is an awful lot higher. That's yield and capital appreciation. What it also says is that, regardless of age, people should always have some income in their portfolio. You know when you're 25, people always say, "Young man or young woman, you have to invest for growth!" Think about if you're retiring now, you would have been 25 in roughly 1971, and someone would have said you need to invest in growth. But actually if you had invested in income during that time, you probably would have been happier today with just compounding the dividends.

Income is not something that is age-dependent, which is what most people think. Everybody should have some income in their portfolio, regardless of how old you are. The proper amount is a question of risk tolerance and not of age. What you find is that older people become more income-dependent. The problem right now is that if we go back 10 or 12 years, everyone wanted capital appreciation and nobody wanted income because of the tech bubble. Now everyone wants income and they don't want capital appreciation. The needle went from one direction to 180 degrees to the other direction, and I think people are being as unwise as they were 10 or 12 years ago because every investor should

have an optimal combination of yield and capital appreciation. Some people say, "What do I live off of, if I don't have this yield?" Well, wait a minute—let's think like a pension or an endowment for a second. An endowment spins off 5% of its portfolio every year by law, so why can't you live off of 5% of your savings every year? Maybe it doesn't have to be 5%. May it should be 2% or 3%, but there is this notion now that people can't live off of their capital gains. And I think that is as unwise as the thinking 10 or 12 years ago. People will have to realize that there should always a mixture of both.

CR: *Bonds have traditionally been safer assets, but now there is concern about what will happen when interest rates rise. How does someone handle the potential for falling prices when bonds have previously been viewed as being safe?*

RB: What is interesting is that people are scared that interest rates are going to rise, but they refuse to hold equities. So the question we have to ask is why would interest rates rise? Interest rates are going to rise as the economy gets stronger. If the economy gets stronger, equities do pretty well. But nobody wants to make that leap. Everyone thinks that interest rates are going up because the Federal Reserve is doing something artificial, the dollar is going to become the peso, we are becoming a third-world country, etc. You can make all of this stuff up, but the reality is that interest rates have been backing up already. They have been backing up because the economy has been getting stronger. People don't seem to believe in the business cycle anymore; we are experiencing a growth business cycle and as that has happened, the stock market has continued to do well. So I don't think people should be so put off.

One area that I would suggest that people are not worried about but should be is non-U.S. bonds, because the dollar is strengthening and emerging market economies have been getting weaker. So it is funny that people are worried about issues in the United States, and they are not even aware that a lot of

the U.S. issues aren't happening in the United States; rather, they are happening in emerging markets. That is probably where the risk is, but most people still don't appreciate the risks in emerging markets.

CR: *Barron's quoted you as saying, "Profit cycles are the most critical part." Can you elaborate on that?*

RB: People spend way too much time looking at GDP [gross domestic product]. Stock markets don't trade on GDP. They trade on corporate profits—the corporate sector. Let's go back to 2009: People were so confused as to how the stock market did so well. One reason is that the corporate sector became the largest percent of GDP ever and corporate profits were actually quite strong. So if you're watching GDP, you're thinking, wow, GDP is 2% so why is the stock market progressing? The answer is because corporate profits are doing so well and corporate profits are the largest percentage of the GDP ever. So people spend too much time looking at GDP and not enough time looking at corporate profits. What you will find is that the driver of things like styles—growth/value, large/small, quality cycles and all the other things people talk about—is the profit cycle. So when profit cycles rev up, you basically want to take on more risk, you want to go down in size, you want to become more cyclical, you want to go away from yield, etc. And when profit cycles roll over and decelerate, you want to become more defensive and more large cap and things like that. It works pretty well over time.

CR: *In terms of analyzing the profit cycle, what time period should investors use to measure it?*

RB: What we do is take the year-to-year change in trailing four-quarter earnings. Any one quarter can be quite volatile, so that doesn't really tell you a lot. So we try to smooth that out over a longer period to look at the fundamentals.

CR: *So for an individual investor, would using the S&P 500 index numbers work?*

RB: Yes, that's what we use: S&P 500 reported earnings. The S&P puts them out all the time; you can get them anywhere.

CR: *What do you look at in terms of asset valuations?*

RB: Asset valuations are a little bit more difficult. We look at them in combination with interest rates and sentiment. We will hear people say that the S&P is selling at 10 times earnings or 15 times earnings or 18 times earnings, and we don't think that gives you enough information. There are times when the price-earnings ratio is 15, let's say, and interest rates have been 1%. There are times the S&P is trading at a price-earnings ratio of 15 and interest rates have been 5%. Are those two similar situations? No, they are not. Where inflation has been 5% and inflation has been 1%—no, they are not the same. So what we like to do is look at those other fundamentals and then compare that to sentiment because what we are always looking for is a gap between the reality of what fundamentals are and people's perception of what those fundamentals are.

Let's talk about the valuation right now, in June 2013, for the stock market.

A lot of people say the market is very overvalued and there is great uncertainty. Financial theory tells you that that is an impossible combination. You cannot have that. You are either going to have uncertainty and undervaluation or certainty and overvaluation. That's called a risk premium. I think most people would agree that there is a fair amount of uncertainty in the marketplace today. If you think there is a fair amount of uncertainty, you should say the market has got a fair amount of value. It is that simple. I think for an individual investor that is all you have to do. They have to say, "Am I certain?" And if they say, "Yeah, this is a really good investment," then they should sit down and say, "Wait a minute, I just said that it is really good." If it is really good and all of my friends think it is really good and everybody in my AAIL chapter thinks it is really good, then is this really going to be an undervalued asset? Probably not. If there is great uncertainty and we can't decide and we're scared to get into it, then we should probably think, well everyone is scared here, maybe there is some value in that asset class. Maybe we should have a little bit in it. But what people do instead is that when they

are uncertain, they say that it is terribly overvalued and when they are certain, it is a bargain. That can't happen.

CR: *You said cash can be treated as an asset class. How does that fit in? Obviously, people have cash in their checking and savings accounts.*

RB: Actually, in the more recent volatility we have experienced, cash is about the only thing that is proving to be diversified right now because people are freaking out about every asset class that is out there, which is a bit odd. Cash can be a diversifier as well. Cash sits at the fulcrum of the seesaw. That is a good way to think about it. What is happening right now is that the seesaw is gyrating like crazy in the short-term volatility, so cash is sitting there looking kind of nice. From time to time, that will happen. Over the longer term, however, we know that cash is a drag on a portfolio. Obviously cash is important for transaction purposes and checking accounts or something like that, but you have to be careful about holding cash for long periods of time.

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