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SPECIALIZING IN INVESTMENT & RETIREMENT PLANNING
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Why Well-Diversified Portfolios Have Lagged the S&P

Some investors have seen minimal returns compared to the benchmark.

Diversification is essential, yet it comes with trade-offs. Investors are repeatedly urged to allocate portfolio assets across a variety of investment classes. This is fundamental; market shocks and month-to-month volatility may bring big losses to portfolios weighted too heavily in one or two classes.

Just as there is a potential upside to diversification, there is also a potential downside. It can expose a percentage of the portfolio to underperforming sectors of the market. Last year, that kind of exposure affected the returns of some prudent investors.

Sometimes diversification hinders overall performance. The stock market has performed well of late, but very few portfolios have 100% allocation to stocks for sensible reasons. At times investors take a quick glance at stock index performance and forget that their return reflects the performance of multiple market segments. While the S&P 500 rose 11.39% in 2014 (13.69% with dividends), other asset classes saw minor returns or losses last year.

As an example, Morningstar assessed fixed-income managers for 2014 and found a median return of just 2.35% for domestic high yield strategies. The Barclays U.S. Aggregate Bond Index advanced 5.97% in 2014 (that encompasses coupon payments and capital appreciation), while the Citigroup Non-U.S. World Government Bond index lost 2.68%.

Turning to some very conservative options, the 10-year Treasury had a 2.17% yield on December 31, 2014; at the start of last year, it was yielding 3.00%. As March began, Bankrate found the annual percentage yield for a 1-year CD averaged 0.27% nationally, with the yields on 5-year CDs averaging 0.87%; last year's average yields were similar.

Oil's poor 2014 affected numerous portfolios. Light sweet crude ended 2014 at just $53.27 on the NYMEX, going -45.42% on the year. (In 2008, prices peaked at $147 a barrel). Correspondingly, the Thomson Reuters/CRB Commodities Index, which tracks the 19 most watched commodity futures, dropped 17.9% in 2014 after slips of 5.0% in 2013, 3.4% in 2012 and 8.3% in 2011. At the end of last year, it was at the same level it had been at the end of 2008.

The longstanding MSCI EAFE Index (which measures the overall performance of 21 Morgan Stanley Capital International indices in Europe and the Asia Pacific region) lost 7.35% for 2014.

At the end of last year, it had returned an average of 2.34% across 2010-2014. So on the whole, equity indices in the emerging markets and the eurozone have not performed exceptionally well last year or over the past few years.

All this is worth considering for investors wondering why their highly diversified, cautiously allocated portfolios lagged behind the main U.S. benchmark. It may also present a decent argument for tactical asset allocation – the intentional, responsive shift of percentages of portfolio assets into the best-performing sectors of the market. Whether an investor favors that kind of dynamic strategy or a "buy-and-hold" approach with a far-off time horizon in mind, it is inevitable that some portion of portfolio assets will be held in currently lagging or underperforming investment classes. This is one of the trade-offs of diversification. In some years – such as 2014 – being ably diversified may result in less-than-desired returns.

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