Diversification: A Failure of Fact or Expectation?

The bear market of October 9, 2007, through March 9, 2009, witnessed not only a 57% decline in U.S. equity prices, but also the demise of many investors' faith in the volatility-reducing effects of diversification. Fortunes were wiped away in this 17-month mega-meltdown that was triggered by the simultaneous popping of the commodity, credit, real estate and emerging equity market bubbles.

During this most recent bear market, which was the second-deepest in the past 80 years, but only the ninth longest of 15, nearly all asset classes—be they U.S. or foreign equities, real estate or commodities—exhibited the glide path of a crowbar, slumping in unison, particularly during the final six months of the bear. Today, as a result, many wonder if traditional "buy-and-hold" investing should be replaced with "run and rotate." They also question if previously uncorrelated asset classes will now forever move in lockstep. Other investors, however, believe that during periods of financial crises, it is typical that equity-oriented or economically sensitive assets will experience positive correlations during these market downturns, only to revert to previous appreciation trajectories once the crisis has passed and they are able to relax once again.

Today, one can unemotionally sift through portfolio embers for clues to seemingly unprecedented asset class performances. We at Standard & Poor's (S&P) conclude that diversification didn't fail investors. Rather, allocation did do its job—a typically balanced portfolio's (60% U.S. large-cap equities and 40% long-term government bonds) 13.1% decline in 2008 was less than the 14.8% fall seen in 1974 and much better than the results of 1931 (–22.2%) and 1937 (–19%).

However, investors' expectations or memories failed. We also believe that many investors simply went too far out on the risk curve, embracing inappropriate equity exposures for their age groups, risk tolerances, or trading acumen. Hopefully, these errors in memory and expectation have been adjusted.

Investor Misjudgments of History

Why did investors hold on so long?

During this sixth "mega-meltdown," or bear market in excess of 40%, in the past 80 years, many investors simply closed their eyes to the financial carnage and maintained their equity exposure as the S&P 500 eventually fell 57%. Allocations were never adjusted, just net worth. We at S&P believe one reason investors—as well as their advisors—chose to do nothing is because many advisors were ardent students of stock market history and, as a result, trained their clients too well, encouraging a “buy-on-the-dip” mentality during all types of market declines.

Yet two mistakes were made along the way. First, we assumed that the financial carnage that occurred prior to World War II was an anomaly and would never be repeated in our lifetime. Second, many believed that “black swan” events, like 100-year floods, occurred so infrequently that they wouldn’t happen again. Unfortunately, 100-year clocks don’t get reset annually.

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