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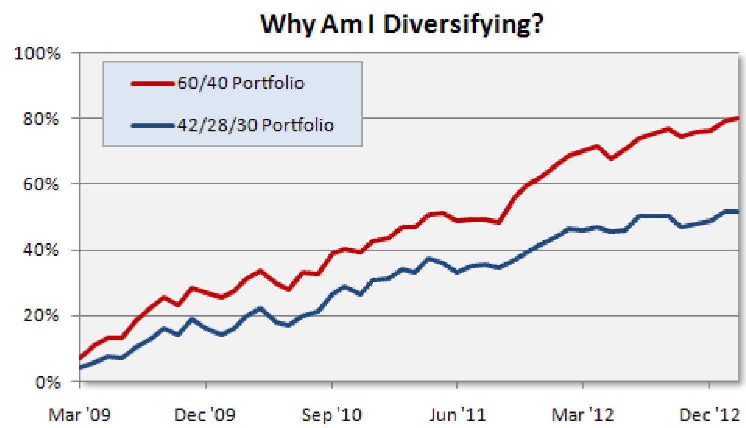
Why Am I Diversifying Again?

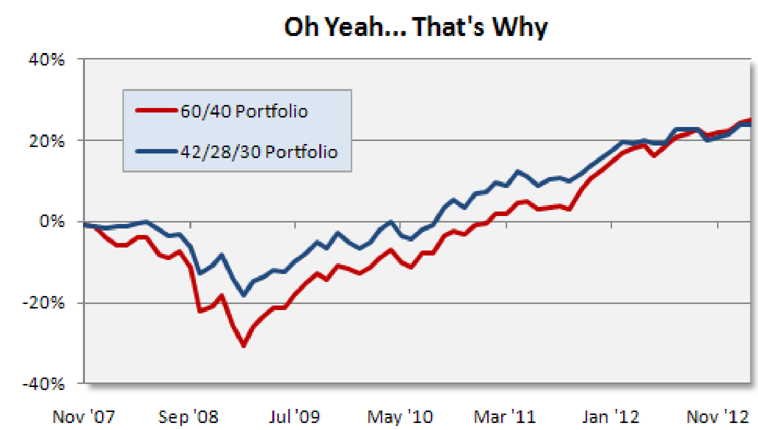
It's not always fun to do the responsible thing. People who pay their insurance premiums year after year may get a little envious when their neighbors spend that money on a new boat. Students who diligently crack open their textbooks on the weekends may pine for the kind of adventures that their less studious classmates are enjoying. And investors who have done the responsible thing and diversified may find themselves gazing longingly at the returns they could be getting if they had only stayed in stocks.

In the long run, the responsible choice is most likely to provide the best outcome and protect you from potentially catastrophic losses – a storm that sweeps away your home, failing your classes and being expelled, or watching a market collapse wipe away your nest egg. But that expectation of future benefits doesn't make it any easier to ignore the feeling that you're missing out. And unfortunately for those who have diversified their investments away from a traditional portfolio, the last few years have been tough to watch.

Why Am I Diversifying?

A quick look at the performance of the traditional 60/40 portfolio versus the supposedly more sophisticated 42/28/30 portfolio – with that 30% exposure in managed futures – surely has many investors question they're diversified in the first place. (If you are wondering where we came up with 42/28? We reduced each part of the 60/40 split by 30%, resulting in the somewhat odd-looking 42% to stocks and 28% to bonds).





60/40 Portfolio = 60% Stocks (S&P 500) + 40% Bonds (Barclays Capital Long-Term Treasury Index). 42/28/30 Portfolio = 42% Stocks (S&P 500) + 28% Bonds (Barclays Capital Long-Term Treasury Index + 30% Managed Futures (Dow Jones Credit Suisse Managed Futures Index). Disclaimer: past performance is not necessarily indicative of future results. The above index results are for illustrative purposes only and do not reflect actual investment gains or losses.

Oh Yeah… That's Why

That big drop in 2008 is the reason you are diversified - the diversified portfolio provides cover during the big drop. Moreover, the diversified portfolio retained its performance advantage over the 60/40 portfolio all the way up to February 2013, even with the 100%+ rally in stocks since the March 2009 low. (Remember, it takes 100% to earn back what was lost in a 50% drop.)

But how many of us really got that benefit during 2007 and 2008? How many of us were diversified *before* the last crash? From where we stand, much of the heightened interest (and investment) in managed futures as a diversifier poured in *after* the great run – meaning a lot of investors are judging managed futures by the first chart above, and not the second.

So, they are asking… Why am I diversifying again? Why am I taking money away from stocks as they make new all time highs?

But the Stock Market's Doing Great Now!

Unless you live under a rock, you have no doubt heard the little tidbit of news (broadcast nonstop by every available media channel in existence) that the Dow (on March 5th) and S&P (on March 28th) have hit new all time highs.

That's right, not just new highs for the year, not new highs since the European crisis, not new highs since the credit crisis (although those are all true as well) – we're talking new all time highs, as in the highest level US stock indices have ever seen.

For those scoring at home, the S&P 500 has put in a gain of 130% since the market bottom to hit these new highs, and the rally has continued in the face of worries about Europe, China, Washington infighting, lackluster economic data… you name it. Stocks just keep going up and up, climbing higher and higher up the wall of worry.

What Goes Up, Must Come Down

Here's the problem for the stock folks – nearly everyone knows this rally (like every other rally in history) will eventually give way to a sell-off, potentially sending people into a panic and driving stocks down -20%, -40%, or -60%. But the whole trick is in the one small detail of when that sell-off happens. The game is earning enough during the good times to offset the bad times when they come.

Which brings us to the current rally. Up until now, the rally has been one long journey to regain past losses, not making new gains. So in truth, we haven't even really gotten to the good times for stocks – it's all been working off the bad times to this point.

But how much more of the good times can we expect? We're a full four years from the depths of the financial crisis, and this bull run sure seems to be getting long in the tooth both in terms of the time it has lasted (49 months) and how much it has gained (roughly 130%). Per data by BofA Merril Lynch via The Big Picture blog, we see that the average bull market since 1929 has been much shorter (31 months) and smaller (104%), while the median bull market even shorter still (13 months) and smaller (74%).

But much of this data includes periods when stocks were simply earning back the losses suffered during the bad times. It is perhaps more telling to look at how long and large the average moves are starting from the point when a new all time high is made. An article from Market Watch this March did exactly that, examining historical market performance after the S&P 500 recovered from a bear market to attain a new high:

	Calendar days between attainment of new high and eventual market peak	Gain between attainment of new high and bull market's end
Best case	2,711	221.6%
Worst case	132	2.3%
Median of all 13 cases since 1954	417	18.4%
Mean of all 13 cases since 1954	644	40.3%

Disclaimer: past performance is not necessarily indicative of future results.

Ok, now we have a better idea of what the current new all-time high environment might look like going forward. The median case was another 417 days until the next market peak, and a gain of 18%. Not too shabby. Even the worst case scenario is pretty good – at 132 days from new highs to a subsequent peak before a sell off.

So, based on this data we have somewhere between 132 and 2,711 days (or about 400 taking the middle case) before our diversifier – managed futures – is really needed in the portfolio. First, however, we would be remiss to not include a reminder that non-correlation is very different from negative correlation. Absolute return investments like managed futures are non-correlated to the stock market – meaning they can make (or lose) money during good periods for stocks (and the same goes for bad periods). It isn't necessarily the case that they will behave as they have the past few years and be a drag on performance while stock markets are going up.

Indeed – recent research on 100 years of trend following indicated that the largest returns for managed futures should come during the largest moves in the S&P 500 – *both* positive and negative).

What's the Breakeven Point?

The problem is that it will be very hard to watch the market keep going up and up for say, another 700 days, when you've got money sitting in your alternatives allocation that's just middling along.

Which got us to thinking - how long would the current rally need to last (at its current pace) before the investor without any managed futures exposure would make enough money to overcome the additional losses he/she would incur in the next selloff by not being diversified?

For example: if a traditional stock/bond portfolio is making $100 more per month than a diversified stock, bond, managed futures portfolio – but will lose $4,000 more during a market crisis period – there will come a point at which the traditional portfolio's outperformance is greater than the amount of savings you would get from the "insurance."

In this example, it would take 40 months to earn the $4,000 that the investor would lose in the crisis by not having diversification.

For our analysis, we calculated the average monthly performance of the traditional 60% stocks/40% bonds portfolio versus the 42/28/30 portfolio outlined above from March 2009 through February 2013. Then we found the average over-performance of the 60/40 portfolio vs the 42/28/30 portfolio from market tops to bottoms in the last two "bubble" crashes. We know – two market crisis periods is a short sample - but we also know that MF has a history of crisis period performance beyond just those two, and we believe the next crash will look a lot more like the last two than the post 9/11 selloff, for example.

	60/40 Perf	**42/28/30 Perf**	**Difference**
2000 Crash	-22.17%	-6.76%	15.41%
2008 Crash	-30.61%	-18.27%	12.33%
Average	*-26.39%*	*-12.52%*	*13.87%*

	Compound Monthly Return Since March '09
60/40 Port.	1.09%
42/28/30 Port.	0.79%
Difference	-0.30%

Past Performance is Not Necessarily Indicative of Future Results

So, assuming the same 0.30% monthly over-performance from the 60/40 portfolio that we've seen over the last 4 years, and assuming that the next crash will display the same approximately 14% over-performance for the 42/28/30 portfolio that we witnesses in the last two bubble crashes, we can then calculate what the breakeven point is where the traditional portfolio's over-performance during the good times would equal the savings diversification provides during the bad times:

	Non Diversified Portfolio		
Rally Continues for:	**Additional Gain Before Crash**	**Loss After Crash**	**Net Gain/Loss**
6 more months	1.83%	-13.87%	-12.04%
12 more months	3.69%	-13.87%	-10.18%
24 more months	7.51%	-13.87%	-6.36%
36 more months	11.47%	-13.87%	-2.40%
Breakeven Point = 44 months			

Past Performance is Not Necessarily Indicative of Future Results

So, the question becomes: do you think this rally has another 44 months in it? It's already been 4 years since the bottom – and 3 more years would be more than double the median length of post-fresh-peak rallies per Marketwatch's study. And that's assuming that managed futures returns remain as anemic as they've been over the last 4 years, which is hardly a guaranteed outcome, either. If you add just a tenth of a percentage point to the 42/28/30 portfolio's monthly return (or subtract it from the 60/40 portfolio's return), the time needed for the 60/40 portfolio to build up a sufficient lead jumps to 64 months.

We're biased, of course, being in the managed futures business – but it sure seems a lot would have to go right for stocks and wrong for managed futures over the next several years in order for removing the diversifier to make sense in the long run.

Avoiding the Swamps

And even if the total return achieved by removing managed futures from the portfolio was higher in the long term – that ignores an important component – the risk of those returns.

This whole exercise ignores the premium investors may place on avoiding drawdowns and volatility. There are many investors who are willing to sacrifice some total return for a reduction in the amount of loss they may encounter during a drawdown phase. There is a psychological advantage to downside protection – mainly, that it helps prevent you from panicking and selling at the bottom. It helps you stay the course. So, in our example – even if this rally continues for 7 more years, and the traditional portfolio ends up ahead of the diversified portfolio by about 12% - would you even be able to see that final result if you had to live through a -35% drawdown versus a -20% drawdown?

It is worthwhile to remember that your diversification isn't in place for what is going on today, but for what may come tomorrow; to realize that the choice to diversify can be a choice to accept smaller positive returns today in return for smaller negative returns tomorrow. And to realize that there is a point of diminishing returns – where the crisis period protection offered by the diversification has to overcome any non crisis period underperformance of the diversified strategy.

At the end of the day – this isn't just about the final return – it is about the journey as well. It's about avoiding the swamps… as the Abraham Lincoln quote popularized lately by the Spielberg movie Lincoln illustrates:

> *"A compass, I learnt when I was surveying, it'll... it'll point you True North from where you're standing, but it's got no advice about the swamps and dessert and chasm that you'll encounter along the way. If in pursuit of your destination, you plunge ahead, heedless of obstacles, and achieve nothing more than to sink in a swamp... What's the use of knowing True North?"*

This is why you buy insurance before the crash. The next pullback might begin tomorrow, or it might not start until 2 years from now, but it would take a very rare streak of uninterrupted stock over-performance before the responsible decision – diversification – wasn't also the best decision for your portfolio.

Jeff Malec, CAIA
CEO & Founding Partner
Attain Capital Management

Comments, Questions – [Click Here]

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The mention of asset class performance is based on the noted source index (i.e. Newedge CTA Index, S&P 500 Index, etc.) , and investors should take care to understand that any index performance is for the constituents of that index only, may not be investable, and does not represent the entire universe of possible investments within that asset class. And further, that there can be limitations and biases to indices: such as survivorship and self reporting biases, and instant history.

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