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The Diversification Illusion

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Since the 2008 financial crisis, I have witnessed plan sponsors of all stripes reassess, react, respond, reconsider and re-evaluate almost every aspect of their investment program. Virtually no stone was left unturned as they searched for solutions to not only recover, but improve future outcomes while hoping to never be caught off-guard by the next financial storm.

Surveying these investors, the most common cure was more diversification. Specifically, adding alternative asset classes such as private equity, private debt, value-added real estate, commodities and invoking a more "global view" to investing. Of course, manager hires & fires within existing asset classes accompanied the asset allocation changes to further shake things up.

The diversification illusion was reinforced by these changes. More managers, more asset classes and more global exposure sought to treat the recent symptoms, but did nothing to cure the sickness.

Water, water, every where,
And all the boards did shrink;
Water, water, every where,
Nor any drop to drink.

Like Samuel Taylor Coleridge's fabled Ancient Mariner, institutional investors also face a paradoxical dilemma. But rather than an unquenched need for life-saving, potable water, institutional investors continue to thirst for vital diversification.

How can this be? After all, institutional investors have gone to great lengths to increase diversification by eliminating unique or unsystematic risks throughout their portfolio. Specifically, institutional investors have carefully taken steps to diversify the following aspects of their portfolios:

- **Asset Class Diversification-** Investing across increasingly different asset classes hoping to achieve desired portfolio risk/return characteristics
- **Active Manager Diversification-** Investing with many different active managers hoping to avoid the risk of concentrated under-performance
- **Portfolio Diversification-** Investing in a portfolio of many different securities within an asset class hoping to avoid unique or unsystematic risks from any single investment

At any *moment in time*, an institutional investor that has followed the above measures can rightly claim to have "diversified away" these risks and thus oversee a diversified portfolio. But *over time*, the global investment landscape changes and investors and their portfolios must change accordingly. Over the last decade, investors need only compare their portfolio at the end of 2007 with 2017. Except for the rarest of investors, your portfolio has no doubt changed, some dramatically.

The changes made to a portfolio *over time* concern:

- **Strategic Asset Allocation**
- **Tactical Asset Allocation**
- **Manager Hires & Fires**
- **Rebalancing**

Who or what entity researches, recommends and executes these portfolio changes *over time?* Virtually all institutional investors rely on a lone source for investment strategy, usually an investment consultant or Chief Investment Officer (CIO.) This structure, by definition, has zero diversification of strategy. Although relying on a lone source of investment advice is common, it is highly problematic.

The problems with following this structure are many and serious, including:

- **Lack of Asset Allocation Strategy Diversification**
- **Lack of Manager Selection Strategy Diversification**
- **Lack of Rebalancing Execution Diversification**
- **Lack of Performance Transparency**
- **Lack of Accountability**

Let us now examine these problems and then later suggest two easy fixes.

Lack of asset allocation strategy diversification should be the greatest concern as asset allocation explains 90% of your outcomes. Capital market assumptions vary widely among investment firms. Further, there are different methods for implementing those market assumptions along with different disciplines to avoid "veiled market timing." Add the fact that virtually all performance reports use Benchmark Linking, and it becomes nearly impossible to know if the changes to your strategic asset allocation added or lost value *over time*. This unknowable risk cries out for diversification.

Lack of manager selection strategy diversification is the next problem with relying on a lone source of investment advice. There are several layers where this discipline is invoked. First there is the active versus passive question: If and where should we use passive management? Second is the question of whether anyone can successfully hire active managers that will out-perform in the future, net of fees, *over time*. (Hint: no one has a proven track record of being able to do that.) Third is the problem of being able to hold onto and/or fire active managers before *future under-performance*; or at least have the discipline to not fire an under-performing manager during periods of negative alpha.

Like the problem with lack of asset allocation strategy diversification, it is very difficult to know if your investment consultant or CIO adds value with their manager selection since they do not track the performance of fired managers. You can read more about this consultant camouflage in my paper Decoding Investment Consultant Alpha. Again, an unknowable risk demands diversification.

Lack of rebalancing execution diversification is a serious problem as this function is an all-or-nothing proposition. Rebalancing is often an afterthought, but this is a mistake. Capturing incremental returns when asset prices (or manager alpha cycles) are low and conversely taking risk off the table when they are high adds significant value *over time*. Like asset allocation and manager selection, it is very difficult to know if your investment consultant or CIO is adding value with their rebalancing decisions. For example, how many investment consultants would make this confession? "Since we last met, the S&P 500 dropped 15% and rebounded back. We did not rebalance into the dip and simply stayed put."

Lack of performance transparency should scare institutional investors because their primary duty is to monitor all aspects of their investment portfolio and process. If they are given performance reports that are inaccurate or withhold important facts, it puts the trustees at risk of not prudently fulfilling their fiduciary duty. Investment consultants face many conflicts of interest when executing their duties. Here are a few examples of questionable performance reporting irregularities I have uncovered for clients:

- Straw Man Benchmarks: Using an inappropriate benchmark that an investment manager should easily beat over time.
- Benchmark Flip-Flopping: Switching back and forth between benchmarks despite no stated or practical changes in manager strategy.
- Universe Shopping: Changing the relative peer universe to make either manager performance or total plan performance look relatively better.
- Plan Benchmark Reconstruction: Altering the plan benchmark by either changing a component or its weighting despite no change in the strategic allocation or manager(s).
- Not Tracking Fired Managers: As noted above, an investment consultant's ability to hire and fire managers is critical. But not disclosing the post-termination performance of fired managers hides the efficacy of this important function.

Lack of accountability stems from the confusion created by the above problems. Institutional investors cannot improve their funding status, future outcomes or even governance if they do not know where to look. Are they themselves making poor decisions? Is the investment consultant making poor decisions? Are the investment managers making poor decisions? Is it the markets? Or is it just bad luck? The overall obfuscation and misdirection in both following a lone investment consultant and solely relying on their incomplete investment reports is the root of the problem.

Given these systemic problems, what is an institutional investor to do?

There is a Solution!

There are two ways to overcome the diversification illusion: unbundling and using multiple, multi-asset class managers. Of the two solutions, I believe the latter solution is faster, better, cheaper and easier to implement.

Unbundling is simply a matter of not concentrating your source of investment wisdom within a lone investment consultant or CIO. Further, separating the performance reporting by hiring an independent and objective performance monitor will solve many conflicts of interest and shine a brighter light on the efficacy of the important investment decisions. Pages 5-7 of my paper Level 2 Diversification: The Missing Level provides greater detail on how to unbundle and overcome the diversification illusion.

The superior path to overcoming the diversification illusion is using multiple, multi-asset class (MAC) managers. Compared to using a lone investment consultant, the benefits are:

- Asset Allocation Strategy Diversification
- Manager Selection Strategy Diversification
- Rebalancing Strategy Diversification
- Real-time Dynamism
- Lower Fees
- Performance Attribution Transparency
- Fewer Conflicts of Interest
- Lower Fiduciary Liability

Benefits Magazine published my article Multi-Balanced Model: The Missing Link in Investment Approaches in July, 2014. It goes into greater detail about the benefits of using multiple, multi-asset class managers. As a follow up to this article, I published on ICEvaluations.com Multi-Balanced Model: Your Questions Answered to address functional aspects for implementing this model.

I hope that this short piece has increased your awareness of diversification in managing an institutional investment plan and where the most important need for it is missing. Please email me at bschroeder@icevaluations.com should you have any questions or comments.