# In Depth...

## *"Diworsification"*

The term "diworsification" was coined by Peter Lynch in his book, *One Up Wall Street*. According to Investopedia, it is the process of investing in too many assets with similar correlations which results in an averaging effect. It occurs when an investor adds investments to a portfolio in such a way that the risk/return trade-off is **worsened**.

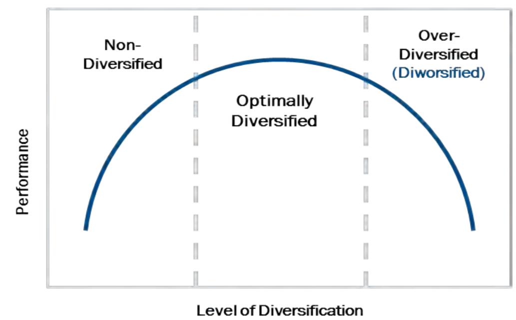
### Diversification to the Point of "Diworsification"

Risk management through diversification is an extremely important discipline. Allocating funds across traditional asset classes like stocks, bonds, real estate and cash means that investors are not "putting all their eggs in one basket" for the inevitable periods of volatility and price declines. However, the most popular trend over the last ten years, particularly after the 2008 recession, has been to over-diversify, or "diworsify," portfolios. The move by large plan sponsors to spread risk across dozens of asset classes (including relatively newer strategies like hedge funds, private equity and commodities) and further diversify by region has led investment plans to have as many as 30–40 asset managers representing 25–30 different asset classes. Many plans have reduced traditional asset classes to make room. In many cases, this has been a considerable drag in the effort to outperform the return target. It also has, most likely, increased fees.

Historically, stock markets around the world, and in particular alternative asset classes like hedge funds and private equity, behaved very differently from the U.S. stock, real estate and bond markets. They were considered non-correlated (i.e., they would often go up when our markets would go down, and vice versa) which provided solid diversification and risk management.

However, over the last ten years, alternative asset classes have behaved similarly and become highly correlated. Therefore, they are not providing the same diversification once enjoyed.

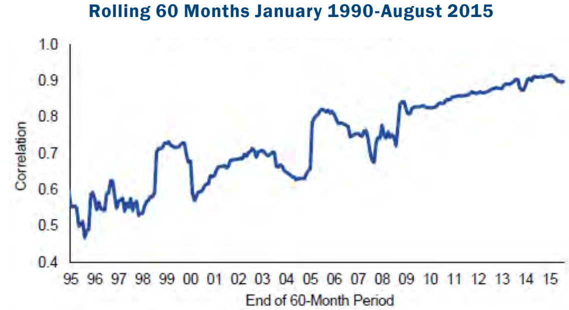
**The Effects of Diversification on Performance**



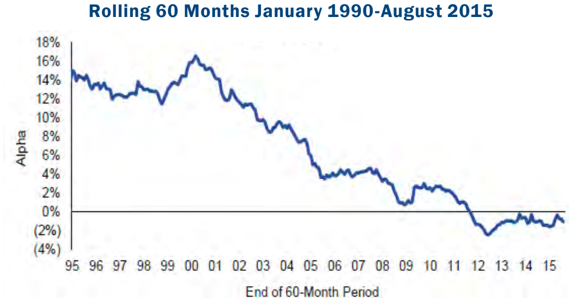

### Alternative Assets — Focus on Hedge Funds

In the mid 1990s, hedge funds provided non-correlated performance. They protected well in stock downturns and gave solid excess returns compared to the risk they took (they truly hedged your portfolio). Today hedge funds are 95% correlated to the stock market (they act the same), but are actually providing less risk-adjusted return with more risk (see graphs below). This is largely due to the sheer number of hedge funds in existence, nearly 10,000. They have become the market.

**Correlation of HFRI Equity Hedge Index with S&P 500**
**Rolling 60 Months January 1990-August 2015**




**Annualized Excess Return of HFRI Equity Hedge Index**
**after Equity Market, Size, Quality and Style Factors**
**Rolling 60 Months January 1990-August 2015**



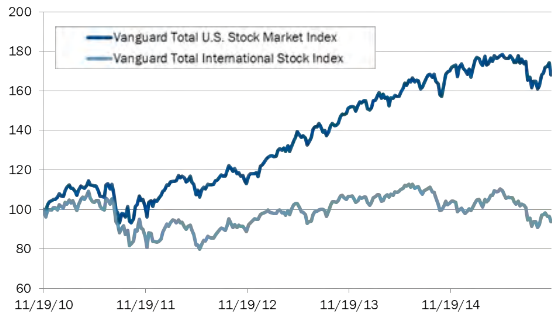

*Source: Thomson Reuters, Morgan Stanley Research*

### International Investing

Correlations of international stocks to U.S. stocks are also approaching 1.0. Prior to 2005, foreign markets traded with far lower correlations providing investors with effective diversification. That has changed, and again the sheer size of the investment capital is driving pricing toward parity in these markets. Foreign markets have traded directionally the same as the U.S. for over ten years, though they have lagged badly, particularly when factoring in currency. Moreover, historical outperformance by international markets was largely driven by the boom in Chinese growth that occurred in the early 2000s. The decelerating China story is now revealing the core fundamentals of the emerging markets and the structural challenges within the European community. Nevertheless, large amounts of institutional assets have been following the investment herd into these regions. This has caused considerable drag on portfolio performance.

Nearly 45% of sales by S&P 500 companies are overseas. Investors would have been much better off diversifying across U.S. asset classes. Diversifying internationally has led many portfolios to "diworsify."

**Vanguard Total U.S. Stock Market Index vs. Vanguard Total International Stock Index Five Years Ending November 16, 2015**




### Factoring the "Herd Mentality" of Investing

Lemming "suicide" is a frequently-used metaphor in reference to people who go along unquestioningly with popular opinion, with potentially dangerous or fatal consequences. One could argue that the trend to over-diversify is a result of such herd mentality — the desire to follow popular opinion. Investing draws on knowledge of accounting, economics and finance, but it surely also requires insight into human psychology. Investors don't always behave according to economic theory; they often behave irrationally. And many times markets fail to react in the way investment theory says they should, and so investors look to hedge, many times with poor results.

While the most popular strategy has been to "diversify" into non-U.S. and alternative assets, the greatest companies in the world have been hiding in plain sight — right here in the U.S! Paradoxically, the least popular call over the last seven years — to "stay home" with your investments in the more traditional asset classes: stocks, bonds, real estate and cash — has been the most successful.

### Stay on Course

At Quest, we believe that there are ample opportunities to diversify in the $26 trillion U.S. stock market. Plan sponsors should seek opportunities in markets with better transparency and diversification opportunities. In the U.S., there are nearly 4,000 companies representing eleven major sectors. Its investors enjoy accounting standards, operational transparency and world-class management overseeing world-class products and services. Investments in U.S. real estate and fixed income also enjoy the same advantages as their stock counterparts.

As this bull market ages, it is narrowing into fewer and fewer "winners." As Wayne Gretzky said, "good hockey players skate to where the puck is; great ones skate to where the puck will be." Quest will continue skating to where the puck will be.

## MUSINGS

**"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."**

**~Mark Twain**

**According to economist Ed Yardeni, the average U.S. household is spending $1,000 per year less on gasoline than a year ago. That adds up to more than $100 billion, at an annual rate, in additional purchasing power for consumers.**