TURNER INVESTMENTS COMMENTARY

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WHY WE DIVERSIFY

WITH OUR OWN MONEY, COOL HAND LUKE WE AIN'T

When markets are good, as they are now, we get brave and emboldened. We assume that the upside will last forever. We drift towards the asset class (often equities) that has been rewarding us and forget all about diversification. Diversification has become a cliché of the investment industry often touted as important but, unfortunately, often ignored. But why, at its core, is diversification so critically important? Because without it, fear takes over. And when we're fearful, we make poor investment decisions.

A quick glance at any Andex chart, which has become one of the most widely used comparative asset-class performance charts, shows you that the best long-term investment/asset class has been US small-cap equities. If you could have bought and held US small-cap equities over the long term, truth is you'd be celebrating right now: rolling in money and waiting on interviews with Robin Leach. So, no problem, right? Just buy US small-cap stocks and forget about it. The problem, of course, is that almost every investor lacks the discipline to buy and hold. Fear, once it takes hold, obscures our better judgement and causes us to sell when we shouldn't. Legendary investor and market historian Peter Bernstein summed it up best in his short, but highly influential, 2002 article "The 60/40 Solution":

> *When [equity markets] are cascading downward, keeping one's cool is almost impossible…. Even if we could imagine a person blessed with sufficient longevity to have been active in the market ever since 1925, how likely would it be that even the most experienced and sophisticated investor would have the self-control to stay 100 percent in stocks, without trading in and out as the market rode up and down its roller coaster? I know I could not have been so calm through depressions, inflations, banking and currency crises, wars and political disruptions.*

Mr. Bernstein died in 2009, but consider how apt his observations are when we look at more recent market events. Could you have maintained a volatile, equity-only portfolio in the face of the Bear Stearns and Lehman Brothers collapse during the 2008–09 global financial crisis with equity markets sometimes plunging 9% in a single day? Held on to your Canadian bank stocks throughout the same period when analysts were regularly debating whether Canadian banks would have to cut their dividends for the first time in modern history? Kept it all together opening your newspaper in 2007 to see the below lineup outside of Northern Rock, at the time Britain's fifth largest mortgage lender, as investors clambered to get at their money in a classic run-on-the-bank? Or, more recently, maintained your cool in the face of a CNBC report that asked during the European sovereign debt crisis "Is the Stock Market Dead?" when it seemed certain that Greece was going to pull out of the European Union and send the world into another devastating recession?

Retail investors often look at long-term equity price charts and say to themselves "I should just buy equities. I can handle the volatility." Truth is: you can't. Long-term charts almost always show that things actually did work out, but unfortunately they can't capture your state of mind during the dark days of plunging markets—and if you're a long-term investor, there are going to be a lot of dark days. So we need to diversify, recognizing that we are unlikely to show good judgement otherwise.

Northern Rock in 2007:
Britian's First Run-On-The-Bank in 150 years

Source: Google Images

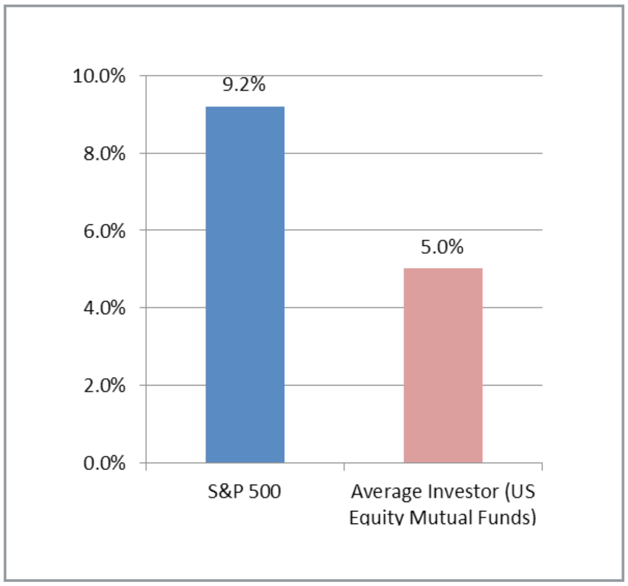
DIVERSIFICATION: BORING, BUT NECESSARY

When invested in an equity-only portfolio, we can't be trusted to make carefully considered investment decisions. We need multiple asset classes in our portfolios in addition to equities, such as bonds, cash, or preferred shares, to control risk, which, in turn, will prevent us from becoming consumed with fear and making poor investment decisions. Don't think we do this? Look at the chart below from investor behavior researcher Dalbar. Over the past 20 years, the S&P 500 Index, a broad measure of the US equity market, has returned 9.2% per year compared to the average retail investor return of only 5.0% per year. Simply put, there's what the *market* does and then there's what the *average investor* does. Without diversification, you're likely to sell at the wrong time and thus underperform the market—probably badly underperform. The second chart shows why this happens. It illustrates the difference in standard deviation (also known as volatility or risk) over time between US equities and US bonds. Notice how much smoother and predictable the bond line looks? Effectively the bonds are "calming" your portfolio and, more than likely, calming you as well. While bond returns have lagged US equity returns recently, this isn't the point. Multiple asset classes, whether they be bonds, cash or preferred shares, control volatility and are necessary components of your portfolio. They prevent fear from overwhelming your better judgement. As Dalbar states: "The value of capital preservation is clear in bear markets but its value is generally ignored in bull markets."

In other words, average investors take on too much risk in bull markets and are often entirely unprepared for bear markets. Subsequently, emotion takes over and, summed up nicely by Dalbar, leads to this:

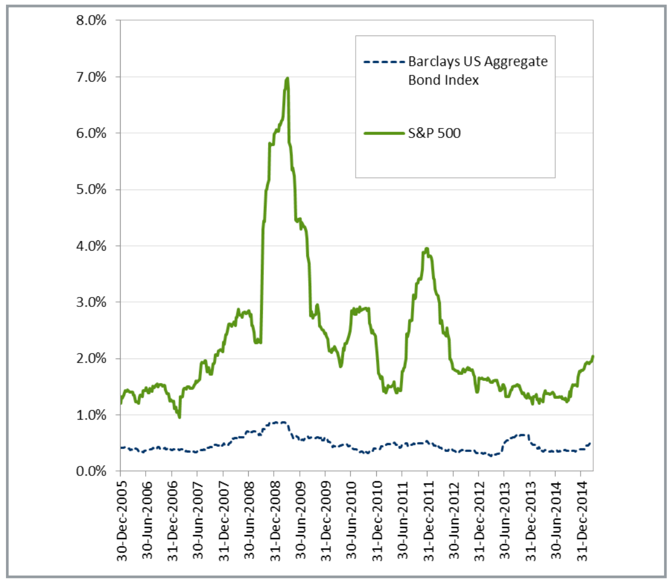
> *Investors tend to sell after experiencing a paper loss and start investing only after the markets have recovered their value. The devastating result of this behavior is participation in the downside while being out of the market during the rise.*

Average Annual 20-Year Total Return



Source: Dalbar

Rolling Standard Deviation: US Equities vs. US Bonds



Source: Bloomberg. Six-month rolling standard deviation. Standard deviation measures the amount of variation or dispersion within a particular index. In other words, it measures the risk of owning that index.

Finally—and we know it's difficult—keep the headline-grabbing numbers you read in the paper or that are splashed across the nightly news in perspective. Typically, they are quoting equity-only returns. This often causes investors to conclude one of two things: 1) why am I not keeping pace with a skyrocketing stock market or 2) the world is ending, I need to sell everything and abandon capital markets forever. Investors rarely consider how a balanced, globally diversified portfolio may be performing. And the answer is likely very simple: probably not quite as good as an equity-only portfolio in the good times, but certainly much better than an equity-only portfolio in the bad times. The returns and reduced risk profile of balanced, globally diversified portfolios don't make for great headlines, but they certainly control emotion. And saving us from making bad, reactionary investment decisions are what diversification and balance are all about.

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