The Whole is Greater than the Sum of the Parts

With thoughtful portfolio construction, investors can potentially achieve significantly better returns at the portfolio level than can be expected from the individual component strategies.

In a diversified portfolio, some components perform better than others over the short or long term. However, looking at the performance characteristics of individual component strategies in isolation and choosing only the highest yielding assets is not necessarily a winning strategy. Diversifying strategies that offer more muted – or even negative – returns versus other components could nonetheless contribute positively to overall returns of the aggregate portfolio.

DIVERSIFICATION ENHANCES COMPOUNDED RETURNS AND REDUCES RISK

Combining assets that perform differently can enhance portfolio returns. A strategy can underperform other portfolio components yet mathematically contribute to better returns at the portfolio level. As shown below, even a strategy with negative returns can contribute positively to the overall portfolio. The benefits of compounding growth and avoiding large losses can have a significant impact on terminal wealth. Even with strong returns over many years, deep drawdowns can have a disproportionate effect on an investment portfolio, making it difficult for an investment to be restored to its former value. Portfolio diversification seeks to mitigate this drawdown risk. Specifically, investors can achieve superior risk adjusted results by allocating to a variety of return sources that have low to negative correlation to each other and complementary performance characteristics.

Example: Negative + Negative = Positive

	Asset A		Asset B		50% Asset A 50% Asset B	
Cumulative Return	-0.05%		-4.12%		7.64%	
Period	Return	NAV	Return	NAV	Return	NAV
		$100.0		$100.0		$100.0
1	8%	$108.0	-2%	$98.0	3%	$103.0
2	8%	$116.6	-2%	$96.0	3%	$106.1
3	8%	$126.0	-2%	$94.1	3%	$109.3
4	8%	$136.0	-2%	$92.2	3%	$112.6
5	8%	$146.9	-2%	$90.4	3%	$115.9
6	8%	$158.7	-2%	$88.6	3%	$119.4
7	-50%	$79.3	15%	$101.9	-18%	$98.5
8	8%	$85.7	-2%	$99.8	3%	$101.5
9	8%	$92.5	-2%	$97.8	3%	$104.5
10	8%	$100.0	-2%	$95.9	3%	$107.6

In the hypothetical example above, two assets that are negatively correlated create a drag on terminal wealth individually. When these assets are combined, they produce positive cumulative returns at the portfolio level.

THE BOTTOM LINE

- Diversifying strategies are a valuable portfolio construction tool that seek to complement – rather than compete with – traditional assets.
- Investors can benefit by considering more holistic methods of asset allocation rather than placing too much focus on individual strategy performance.
- Component strategies with disappointing or even negative returns can ultimately be important contributors to performance at the portfolio level.

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