A sixth year of stock market gains may have rung hollow for some investors as most segments of global financial markets failed to keep pace with many of the popular domestic stock market benchmarks in 2014. The broad S&P 500 Index and the Nasdaq Composite Index finished the year up 13.7% and 14.8%, respectively. Investors taught not to keep “all their eggs in one basket” and diversify their stock investments were left wanting more, as their investment performance trailed these broad U.S. benchmarks.

BIGGER WAS BETTER IN 2014

The gap between the S&P 500 Index, which primarily consists of large company stocks, and other investment categories was significant in 2014 [Figure 1]. Without a significant chunk invested in large cap U.S. stocks, investors very likely lagged the popular S&P 500 Index by a notable margin in 2014. Even high-quality bonds, which benefited from the steady and surprising tailwind of lower interest rates, did better than international or small company stocks in 2014.

It’s not just 2014; diversification failed to benefit investors two more times in recent years. In fact, the S&P 500 Index has outperformed an equal-weighted portfolio of mid cap stocks, small cap stocks, developed foreign stocks, and emerging markets stocks combined by an average of roughly 5% in three of

Source: LPL Research, S&P, Russell, MSCI, Barclays 12/31/14

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.
the past four years. During 2008 and the financial crisis, diversification among stocks detracted from performance, but not to the degree witnessed in three of the past four years. Not since 1998 and the Asian Crisis, when international stocks suffered and small and mid cap stocks also underperformed, has such a large performance gap between the S&P 500 Index and the other segments of the global stock market existed.

**NO SINGLE EXPLANATION**

The ineffectiveness of diversification has left investors looking for answers, but there is no single driver. U.S. dollar strength in 2014 explains foreign underperformance, but the dollar was only marginally stronger against a basket of currencies in 2011 and 2013, and therefore does not help to explain underperformance in these years. Rising correlations, the degree to which asset prices move together, are also suspected for diversification failure. However, high correlations in the early to mid-2000s did not prevent diversification benefits to help investors. Correlations remained high in 2011 yet diversification failed in that year. Record volatility in financial markets worked against diversification in 2008, to no surprise, but not to the degree witnessed in recent years, and diversification worked during the recession of the early 2000s. It is likely that currency, changing correlations, and changing levels of market volatility all played a role in the benefit, or lack of it, in equity diversification, but no consistent explanation exists.

**CYCLICAL, LIKE FINANCIAL MARKETS**

The potential benefits of diversification are often cyclical, like the nature of investments, and change over time. Over the past 15 years, a period that includes two recessions, diversification has worked more often than it has not [Figure 2]. The benefit, or penalty, of diversification can go on for long periods of time—often years. In recent years, there has been a diversification penalty. Over time, we expect this condition to reverse, just as it has historically, and diversification will likely benefit investors once again.

**DIVERSIFICATION IS NOT DEAD**

Diversification still adds value for a long-term investor, as Figure 3 illustrates. Over the past 15 years, an investor would have enjoyed better investment returns, and with less risk, with a

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**Figure 2: Diversification Benefits Can Change Over Time**

Source: LPL Research, S&P, MSCI, FTSE, and Russell index data 12/31/14

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not protect against market risk.
diversified stock portfolio and a small allocation to real estate rather than a concentrated holding of big company stocks as represented by the S&P 500 Index [Figure 3].

Not only did the diversified portfolio outperform over the past 15 years, but it did so with less risk. The diversified portfolio (consisting of 30% large company stocks, 20% mid cap, 20% small cap, 10% developed foreign, 10% emerging markets stocks, and 10% real estate) outperformed the S&P 500 by 2.9% annualized. The average annualized return of the diversified portfolio was 7.1% versus 4.2% for the S&P 500 Index. Portfolio risk, which accounts for the variance in performance up or down, is measured by standard deviation and is less over the time period for the diversified portfolio. Not only did the diversified portfolio provide greater returns but did so with a smoother ride along the way.

During the 1990s, diversification both aided and hurt investors. In 1998 and the two years leading up to it, diversification was a drag as large cap stocks once again proved tough to beat. Still, even with this impact, the diversified portfolio still proved its worth. Over the 20- and 25-year periods ending December 31, 2014, the diversified portfolio delivered slightly greater returns than the large cap S&P 500—only portfolio but slightly more risk.* However, the Sharpe ratio, a measure of risk adjusted performance, was roughly equal for each portfolio.

Including bonds, a powerful diversifier to stocks, adds another layer to the diversification debate. A portfolio of 60% diversified stocks and 40% high-quality bonds provided a smoother ride still for investors. The stock-bond portfolio provided a return of 6.9% over the same 15-year period but with much less volatility. In fact, measuring investment return relative to the amount of risk produced the stock-bond portfolio proved better risk-adjusted return despite a lower overall total return.

**PROTECTING AGAINST UNPREDICTABILITY**

Investment leaders and laggards change most years and sometimes by a significant margin [Figure 4, page 4]. High-quality bonds were laggards for four consecutive years before providing a big benefit to investors in 2007 and 2008, and were subsequently lagging again in 2009 and 2010. In sum, bonds were

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*Diversification Still Works Over the Long Term*

![Graph showing growth of $10,000 in diversified equity versus S&P 500 from 2000 to 2015.]

**Source:** LPL Research, S&P, MSCI, Russell 2/11/15

This is a hypothetical example and is not representative of any specific investment. Your results may vary. Past performance is no guarantee of future results.

*For the trailing 20-year period the diversified equity portfolio returned 9.95% versus 9.85% for the S&P 500, on an annualized basis. The Sharpe ratio of each portfolio was .45 and .47, respectively. For the trailing 25-year period, the diversified equity portfolio returned 10.04% versus 9.62% for the S&P 500, on an annualized basis. Each portfolio had a Sharpe ratio of .44.*
Laggards in six out of eight years during the 2000s but still provided investors a key diversification benefit at a key time. During the mid-2000s, emerging markets equities were often a leader but have been less impactful in recent years. Figure 4 illustrates how asset classes go through periods of relative strength and weakness over lengths of time. Furthermore, the whipsaw in investment performance across sectors from 2008 and 2009 shows how markets can overshoot during periods of gloom and doom and can similarly do so to the upside. Predicting which sector will lead in any given year is an impossible task, and diversification can help buffer against the unpredictable swings.

Diversification also serves as a reminder of what an investor is seeking to achieve. Whether it is a smoother ride to their financial goals with a stock and bond mix, or a longer time frame where a greater allocation of stocks is warranted, diversification can still help you meet both objectives.

**4 PROTECTING AGAINST UNPREDICTABILITY**

Source: LPL Research, S&P, Russell, MSCI, FTSE, Barclays, Bloomberg 2/12/15
IMPORTANT DISCLOSURES

All performance referenced is historical and is no guarantee of future results.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

All indexes are unmanaged and cannot be invested into directly.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies. Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors.

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This research material has been prepared by LPL Financial.