Diversifying Portfolios for Early 21st Century Markets

Diversifying investments across asset classes is a commonly used tool to help smooth investor returns. For example, investing across global markets was considered to be a reliable way to increase risk-adjusted returns for many years. And bonds have long been added to equity portfolios in an effort to soften the ride should equities falter. However, many investors have found that this approach did not provide the same protection and risk-adjusted return benefit over the last decade that it did during the 1990s.

Following this experience, recent research from State Street[1] and Ned Davis Research (NDR)[2] reexamines traditional diversification methods. In this brief paper we summarize some key takeaways from this research, focusing on the rise in correlations[3] between equity markets and many other asset classes globally, the challenges that this development has presented for asset allocation, and possible methods to help protect client portfolios going forward.

Asset Class Correlations

As shown in *Exhibit 1* on the following page, the correlation between US and international large cap stocks has drifted upward, rising from 0.59 for the 10 years ending in 2000 to 0.89 for the period 2001 through 2010. So while in the 1990s these two asset classes only moved in the same direction a little more than half of the time, during the most recent decade they moved in the same direction nearly 9 times out of 10. One reason for larger positive correlations among global stocks may be the fact that equity markets have become highly interdependent as company operations have become increasingly global.

Exhibit 1 reveals a similar trend of climbing correlations across *all* equity asset classes from US small cap to international developed and emerging markets. REITs (real estate investment trusts) also strongly aligned with stocks around the time of the financial crisis. Clearly, another significant driver of higher correlations is the market stress that arose with the dramatic 2008 downturn, where many asset classes fell sharply in unison. State Street observes that extreme risk aversion, as opposed to rational analysis of fundamental value, often drives the decisions made by investors during economic and market crises.

State Street concludes that returns are "more diversified on the upside and considerably less on the downside—precisely the opposite of what most investors are seeking." The result is that returns for portfolios employing standard diversification strategies are generally lower for diversified than non-diversified portfolios when markets are climbing, yet these same strategies offer little protection from severe market drops.

Returns for portfolios employing standard diversification strategies are lower for diversified than non-diversified portfolios when markets are climbing, yet these same strategies offer little protection from severe market drops.

[1] "Rethinking Asset Allocation," State Street Vision Focus (June 2010). Published by State Street Corporation.
[2] Lance J. Stonecypher and Chay Norbom, "Big Implications for Stock Pickers—Correlations May Stay Elevated," Ned Davis Research Trends & Themes (July 21, 2010).
[3] Correlation is a statistic that measures how two securities move relative to each other. A correlation of 1 indicates that two assets move in the same direction, a correlation of -1 indicates that they move in opposite directions, and a correlation of 0 indicates no relationship in the movements of the two assets.

Exhibit 1.

Ten-Year Correlations of Asset Classes — Point in Time

	January 1991 - December 2000							January 2001 - December 2010						
	US LC	US SC	Int'l Dev.	Int'l EM	REITs	Fixed Inc.	Cash	US LC	US SC	Int'l Dev.	Int'l EM	REITs	Fixed Inc.	Cash
US LC	1							1						
US SC	0.65	1						0.89	1					
Int'l Dev.	0.59	0.51	1					0.89	0.82	1				
Int'l EM	0.61	0.64	0.54	1				0.82	0.79	0.89	1			
REITs	0.29	0.43	0.20	0.27	1			0.66	0.74	0.64	0.56	1		
Fixed Inc.	0.32	0.13	0.15	-0.03	0.23	1		-0.08	-0.12	0.02	0.02	0.13	1	
Cash	0.07	0.02	-0.09	-0.17	0.09	0.21	1	-0.06	-0.08	-0.06	-0.03	-0.06	0.01	1

KEY

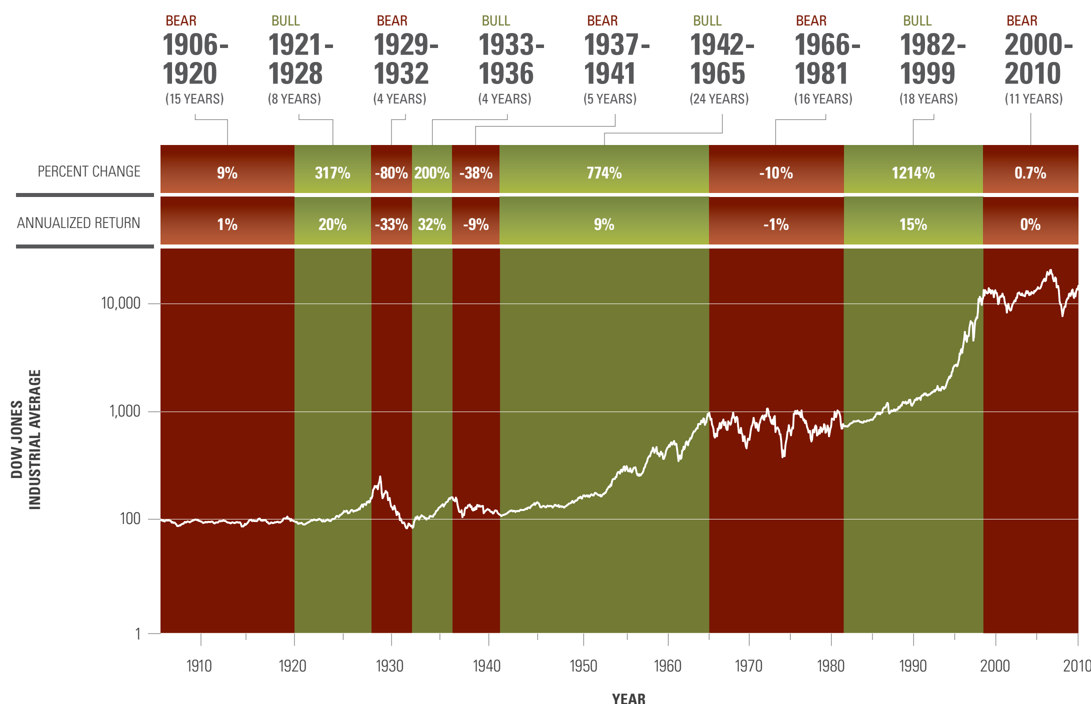
US LC—US Large Cap, represented by S&P 500; US SC—US Small Cap, represented by Russell 2000; Int'l Dev—International Developed, represented by MSCI EAFE; Int'l EM—International Emerging, represented by MSCI Emerging Markets; REITs—REITs, represented by FTSE Nareit Equities; Fixed Inc—US Fixed Income, represented by Barclays Capital US Aggregate; Cash—Cash, represented by Citigroup 3 month T-Bill. See index definitions on page 6.

Source: Zephyr StyleADVISOR.

Exhibit 2.

Long-Term Market Cycles

Dow Jones Industrial Average from Jan. 1906 to Dec. 2010



Past performance is no guarantee of future results. Used with permission: Crestmont Research, www.crestmontresearch.com. Crestmont Research, founded by Ed Easterling, provides secular market research support to Genworth Financial Wealth Management. The Dow Jones Industrial Average ("Dow"), a registered trademark of Dow Jones & Co., Inc., is an unmanaged index composed of 30 common stocks. It is not possible to invest directly in an index. Returns shown above do not reflect the reinvestment of dividends or other distributions; these total return figures are not available for the Dow prior to October 1987. Returns shown represent only the price appreciation of the index.

Both State Street and NDR suggest that periods of market turbulence associated with the long-term bear market that began a decade ago may recur for some time into the future. (*Exhibit 2* on the previous page illustrates the history of long-term bull and bear markets.) In the context of expected continuing volatility, NDR also points out that asset classes as varying as currencies and commodities may continue to offer less diversification going forward.

Investing in a Rapidly Changing World

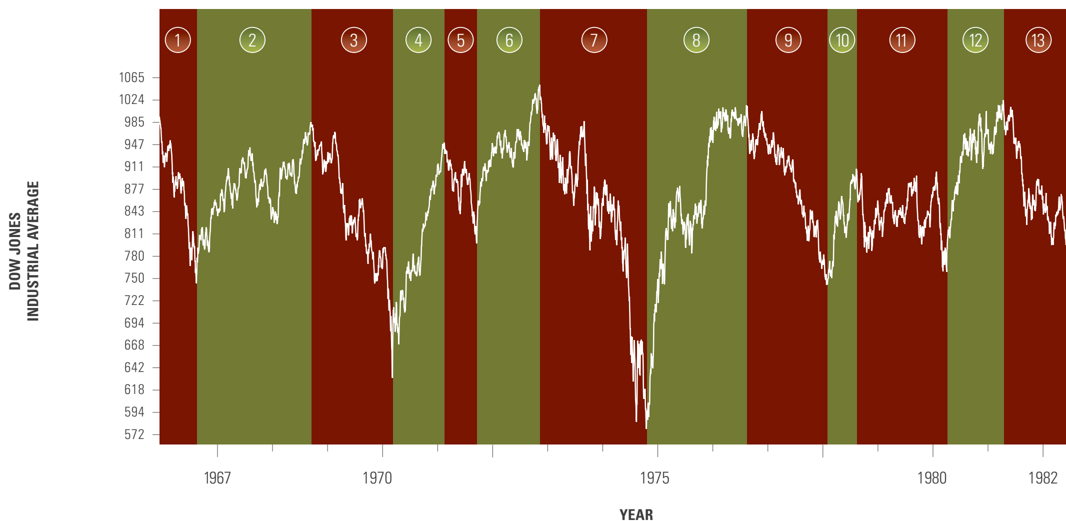
Exhibit 3 below uses the example of the long bear market from 1966 through 1982 to illustrate the rapidly alternating short-term bull and bear periods that may occur within a long-term bear market. NDR points out that, in today's markets, the additional factors of ETFs (exchange traded funds) and computerized program trading "act like lenses, magnifying systemic market swings." Similarly, State Street describes the "accelerating speed and volatility of markets" and emphasizes that relying on long-term average correlations to gauge risk exposure is insufficient today. Instead, they recommend that portfolios be stress-tested for periods of high market turbulence.

Exhibit 3.

Long-Term Bear Market

Dow Jones Industrial Average: 1966-1982

Market Period	1	2	3	4	5	6	7	8	9	10	11	12	13
Time (Years)	0.7	2.2	1.8	0.7	0.6	1.1	1.9	1.8	1.4	0.5	1.7	1.0	1.3
Percent Change	-21.28%	27.24%	-22.38%	23.17%	-11.70%	22.70%	-39.35%	60.05%	-25.05%	18.15%	-6.82%	22.11%	-18.96%



Past performance is no guarantee of future results. Cyclical market data courtesy of Ned Davis Research. Used with permission. Further distribution prohibited without prior permission. ©2011 Ned Davis Research, Inc. All rights reserved. Return data sourced from Bloomberg. Total cyclical market returns are calculated using the closest month ends. The Dow Jones Industrial Average (a registered trademark of Dow Jones & Co., Inc.) is an unmanaged index composed of 30 common stocks. It is not possible to invest directly in an index. Returns shown above do not reflect the reinvestment of dividends or other distributions. Returns shown represent only the price appreciation of the index.

Planning for Ever-Changing Markets

In response to the experience of the financial crisis and continuing uncertainty, investors may move to preserve capital by constructing portfolios that aim to capture some market gains and protect against some market losses. Specifically, investors may choose to enhance risk management by supplementing traditional asset class diversification with a more thoughtful mix of strategies that are designed to position portfolios for a variety of market environments. Of course, asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

One approach found by State Street to have benefited portfolios during the financial crisis was the blending of "convergent" and "divergent" strategies. Convergent strategies analyze fundamental data to determine the value of an investment and divergent strategies focus on trends and sentiments. Convergent strategies often do well in quieter periods, while divergent approaches tend to perform better when the market is volatile.

Given that conventional asset classes plummeted together during the financial crisis, it makes sense to incorporate divergent strategies, which are constructed to be less dependent on the stock market for their returns, into investment portfolios. Many divergent, or non-traditional, approaches are designed to mitigate the downside volatility that has been shown to be a feature of market-dependent strategies.

Likewise, NDR suggests that more flexible asset allocation strategies could be beneficial, and adds that alternative market exposures could help diversify portfolios. As a caveat, however, it still makes sense for many people to have exposure to sufficient market-oriented strategies because this is of great importance when the stock market makes definitive upward moves.

In a fast-changing world, working with your financial advisor to thoughtfully construct your portfolio to be well-positioned for the extremes of bull and bear markets may be the most important investment decision you can make.

Combining Market-Convergent and Market-Independent Strategies

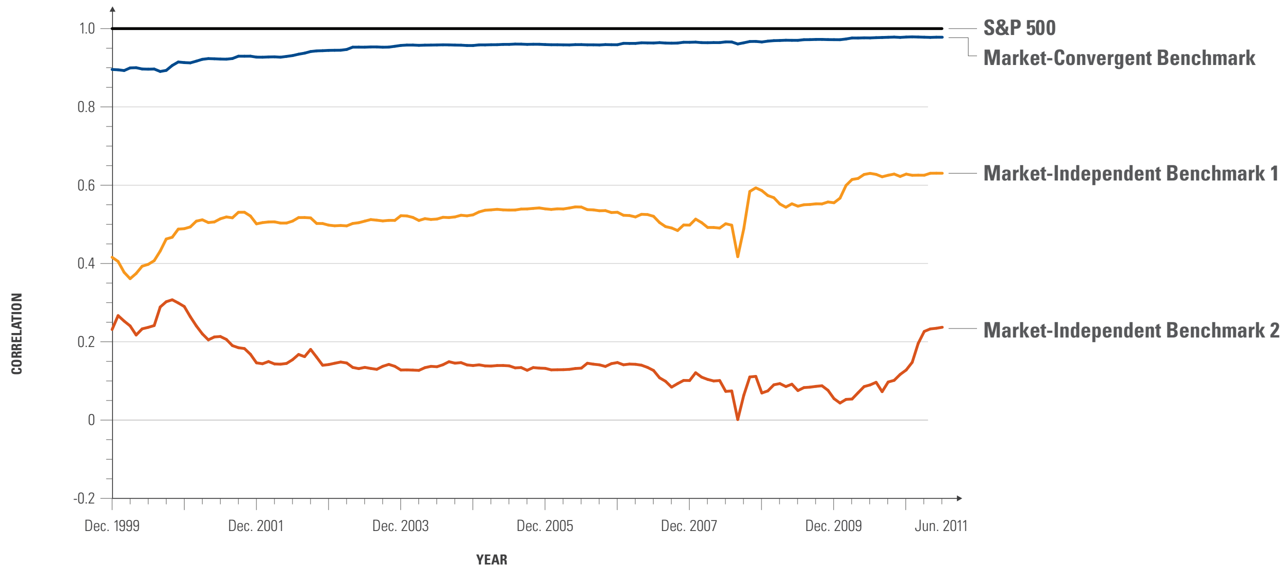
Exhibit 4 on the following page tracks the rolling 10-year correlations of market-convergent and market-independent indexes with the S&P 500 Index. This exhibit indicates that combining market-convergent and market-independent strategies may have provided a significant diversification benefit over the past two decades. The investment philosophy of Genworth Financial Wealth Management (GFWM) is centered on the concept of preparing portfolios for ever-changing markets by combining market-convergent and market-independent strategies:

Our "sailing" approaches—Strategic and Tactical Constrained℠—position portfolios for rising and relatively quiescent markets, including short-term bull market rallies that occur within long-term bear markets. These strategies are market-convergent, designed to take advantage of market upswings.

Exhibit 4.

Performance of Asset Allocation Approaches

Rolling Ten-Year Correlations to the S&P 500 for periods ending Dec. 1999 to Jun. 2011



The Market-Convergent Benchmark is a blended US and international equity benchmark that includes 59% Russell 3000 Index, 39% MSCI EAFE (international) Index, and 2% cash. The Market-Independent Benchmark 1 is the HFRI (Hedge Fund Research, Inc.) Fund of Funds Composite Index, an index of hedge fund of funds. Hedge funds are funds that are not tied to a market benchmark and funds of funds are funds that invest in other funds.[4] The Market-Independent Benchmark 2 is the HFRI Equity Hedge: Equity Market Neutral Index, which is based on portfolios that are designed to be neutral to one or more variables, such as broader equity markets.[5] See index definitions on page 6. *Source: Zephyr StyleADVISOR.*

GFWM also offers "rowing strategies"—Tactical Unconstrained℠ and Absolute Return. These are market-independent approaches that may be better suited to navigating stormy bear markets. "Rowing" strategies "de-link" from the market and have far greater flexibility to incorporate non-traditional asset classes and alternative strategies and, in some cases, minimize market exposure.

While the best combination of strategies will vary with your individual goals and risk tolerance, combining "sailing" and "rowing" strategies may help your portfolio better withstand a variety of market environments. Of course these strategies are subject to market risk, and the amount invested, when liquidated, may be worth more or less than the amount originally invested, so there is no assurance that they will be successful. Nevertheless, in a fast-changing world, working with your financial advisor to thoughtfully construct portfolios that are designed to be well-positioned for the extremes of bull and bear markets may be the most important decision that you as an investor can make.

[4] The HFRI Fund of Funds Composite Index reflects hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within the HFR database. Fund of funds strategies design a diversified portfolio of managers with the objective of significantly lower the risk (volatility) of investing with an individual manager. The Funds of funds composite includes only funds of funds strategies and these strategies are classified as conservative, diversified, market defensive or strategic.

[5] The HFRI Equity Market Neutral Index reflects hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within the HFR database. Equity market neutral strategies employ sophisticated quantitative techniques for analyzing price data to ascertain information about future price movements and relationships between securities, and select securities for purchase and sale. Equity market neutral strategies typically maintain net equity market exposure no greater than 10% long or short.

Important Information

For the asset class performance charts, the following is a list of the indices used and a brief definition.

- **Barclays Capital US Aggregate Index**: a broad-based index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABSs, and CMBs.
- **Citigroup 3-Month T-Bill Index (Cash)**: an unmanaged index of three-month Treasury bills.
- **Dow Jones Industrial Average Index**: an index of 30 stocks that represents large and well-known US companies and covers all industries with the exception of Transportation and Utilities.
- **FTSE NAREIT Equity Index**: a broad measure of the performance of publicly traded real estate securities, such as Real Estate Investment Trusts (REITs) and Real Estate Operating Companies.
- **HFRI (Hedge Fund Research, Inc.) Equity Market Neutral Index**: an index based on portfolios that are designed to minimize or eliminate equity market exposure.
- **HFRI (Hedge Fund Research, Inc.) Fund of Funds Composite Index**: an index of hedge fund of funds. Hedge funds are funds that are not tied to a market benchmark and funds of funds are funds that invest in other funds.
- **MSCI EAFE Index (Europe, Australasia, Far East)**: a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of developed markets, excluding the US and Canada.
- **MSCI Emerging Markets Index**: a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity performance of emerging markets.
- **Russell 2000 Index**: an unmanaged index consisting of 2000 companies considered to represent the small cap segment of the US equity market.
- **Russell 3000 Index**: an unmanaged index consisting of those companies considered to represent the large, mid and small cap segments of the US market.
- **S&P 500® Index**: an index of 500 leading companies in leading industries of the US economy, capturing 75% coverage of US equities.

Asset Class Risks

- Investments in foreign securities may present risks not associated with investing solely in the US, such as currency fluctuation, political and economic risk, differences in accounting standards and limited information. Investments in emerging markets can magnify these risks.
- The prices of small and mid cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.
- There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions.
- The prices of fixed income securities fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.
- Hedge funds are complex, speculative investment vehicles and are not suitable for all investors. They are generally open to qualified investors only and carry high costs, substantial risks and may be highly volatile. There is often limited (or even non-existent) liquidity and a lack of transparency regarding the underlying assets. They do not represent a complete investment program. The investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Hedge funds are not required to provide investors with periodic pricing or valuation and are not subject to the same regulatory requirements as mutual funds. Investing in hedge funds may also involve tax consequences. Speak to your tax advisor before investing. Investors in funds of hedge funds will incur asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investment in a hedge fund involves the risks inherent in an investment in securities, as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-US securities, "junk" bonds and illiquid investments. There can be no assurances that a manager's strategy (hedging or otherwise) will be successful or that a manager will use these strategies with respect to all or any portion of a portfolio. Please carefully review the Private Placement Memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as other factors you should consider before investing.

Notes

Genworth Financial
Wealth Management, Inc.
2300 Contra Costa Blvd.
Suite 600
Pleasant Hill, CA 94523
800-664-5345

GenworthWealth.com

Capital Brokerage Corporation
(dba Genworth Financial Brokerage
Corporation in Indiana)
6620 West Broad Street,
Building 2
Richmond, VA 23230
Member FINRA

For complete information on all of the advisory services offered through the Genworth Financial Wealth Management platform, including information on all applicable fees, please refer to the appropriate Disclosure Brochure which can be obtained from your financial advisor.

Crestmont Research, founded by Ed Easterling, provides secular market research to Genworth Financial Wealth Management (GFWM). His book, Unexpected Returns: Understanding Secular Stock Market Cycles, discusses the Sailing and Rowing analogy which is also used by GFWM to describe asset allocation and portfolio construction strategies.

Capital Brokerage Corporation and Genworth Financial Wealth Management, Inc. are wholly owned subsidiaries of Genworth Financial, Inc. Crestmont Research is not affiliated with any Genworth Financial company.

Genworth Financial Wealth Management is an investment advisor registered with the Securities and Exchange Commission. ©2011 Genworth Financial Wealth Management, Inc. All rights reserved. Genworth, Genworth Financial and the Genworth logo are service marks of Genworth Financial, Inc.

3920 | C2042 | 09/15/2011