ABR Dynamic Funds – 4Q 2024 Newsletter

The Power (and the Pain) of Diversification

Diversification is all about balance. It means never putting all your eggs (or your enthusiasm) into one basket. A well-diversified portfolio isn't meant to ride the highs of an S&P 500 bull market any more than it's meant to soar in a strong bond rally. Every investment plays its part, contributing to the bigger picture.

Over the long run, a diversified approach has historically delivered better outcomes. The challenge? Fighting off the temptation to chase runaway equity markets. It's tough watching stocks soar and resisting the urge to go all in. But remember: the business news flashing green arrows and record highs might have little to do with a portfolio's long-term health.

The Last Three Years: A Tough Ride for Diversified Investors

The past three years have been frustrating for diversification. It offered only minimal cushioning during the first half of 2022, and it hasn't kept pace with the traditional 60/40 portfolio since then. In fact, those feeling good about their performance over the past three years may want to double-check just how diversified they really are.

Numbers don't lie:

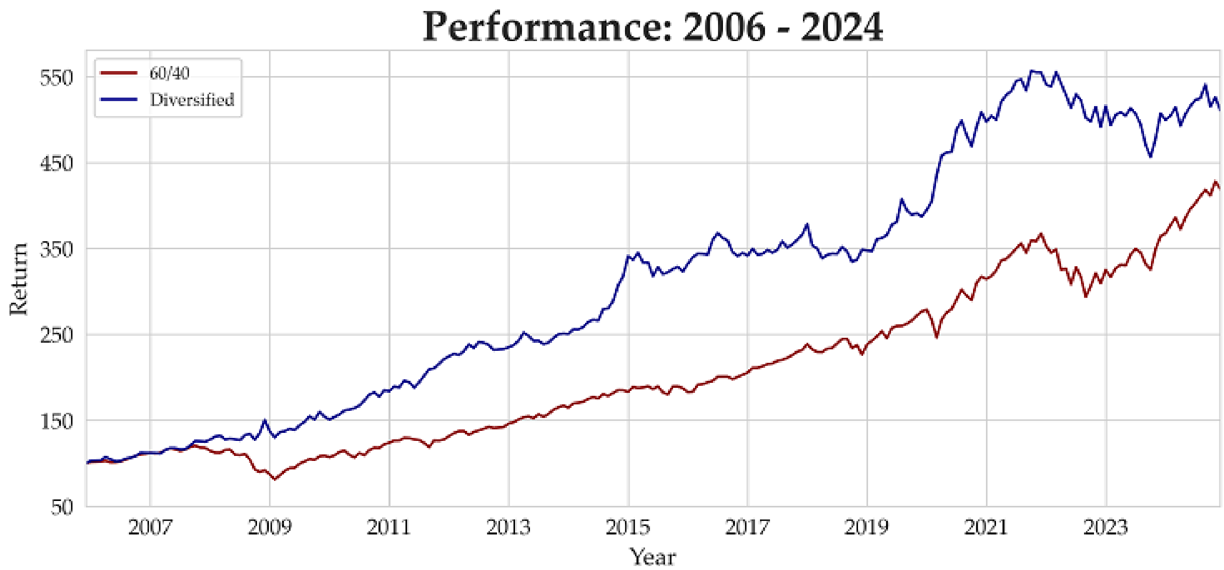
	Return	St Dev	Sharpe	Sortino	Down Dev	Beta	Alpha	Treynor	MAR	Max DD
60/40	4.5%	12.9%	0.04	0.08	6.9%	1.00	0.000	0.01	0.22	-20%
Diversified	-2.7%	10.6%	-0.63	-1.36	4.9%	0.68	-0.070	-0.10	-0.15	-18%

That 7%+ annualized underperformance grew to a 22% lag in cumulative return over three years, and that's despite a 20% S&P 500 drop in early 2022 – exactly the type of scenario where diversification is supposed to shine.

So, Why Stick With It?

Because history tells us it works. Not always, not perfectly, and certainly not in predictable short-term bursts – and not well over the past three years – but over a full investing lifetime, diversification has provided better results and a smoother ride.

Take a bit longer look:



	Return	St Dev	Sharpe	Sortino	Down Dev	Beta	Alpha	Treynor	MAR	Max DD
60/40	7.8%	9.7%	0.63	0.84	7.3%	1.00	0.000	0.06	0.24	-33%
Diversified	9.0%	9.7%	0.75	1.26	5.8%	0.46	0.044	0.16	0.50	-18%

Is This Time Different?

There's no reason to think so. Short-term underperformance isn't new. It has happened before, and yet diversified portfolios have delivered better long-term outcomes.

Skeptics argue that AI, innovation, and modern market dynamics have rewritten the rules. That's eerily familiar to the "new paradigm" talk of the late 1990s during the dot-com boom. A better question may be: is today's market more like 1996 (with more runway left) or 1999 (on the brink of trouble)?

The good news? In either case, patience and discipline have historically rewarded diversified investors. The challenge? Accepting that no one truly knows what's next.

For example, ten to fifteen years ago, the consensus was that small-cap and emerging market stocks would dominate. The logic made sense, but the real reason for those forecasts was outperformance over the ten to fifteen years before that. However, those once-obvious forecasts have since been painfully disappointing. What seems inevitable today might look foolish in hindsight.

So, what will be "obvious" ten to fifteen years from now? That's the big question – probably unanswerable ahead of time – but it can also be the irrelevant question. Diversification isn't about predicting the future. It's about being prepared for as many possible futures as one can be.

Disclosures:

“60/40” is represented by 60% S&P 500 (SPXT Index) and 40% US Aggregate Bonds (LBUSTRUU Index). “Diversified” is represented by 43.5% each of S&P 500 (SPXT Index), long-dated US Treasuries (LT11TRUU Index), conventional trend-following managed futures (CSLABMF Index), and long volatility (EHFI451 Index), net of an estimated cost of leverage. 43.5% was chosen as a simple illustration of equal parts of 4 diversifying allocations that resulted in the same risk, measured by standard deviation of monthly returns, as the 60/40 approach over the full period from 2006-2024.

Note that this approach is by no means as diversified as an investor may have been. Nor is the result as bad as it may have been. For example, over these last three years, the S&P 500, with its focus on large-capitalization US stocks was up 29.3%, while the more diversified MSCI World Equal Weighted Index (M1WOEW Index) was up only 4.6% (both figures are cumulative, not annualized).

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