AllianceBernstein®

# NEXT GENERATION DIVERSIFICATION

Investment diversification is far from a new concept. Research papers on portfolio theory were published throughout the 20th century and, in the past several decades, investors have come to expect conversations on well-diversified portfolios. However, markets change and evolve over time. To have a better chance of long-term success, investors need to rethink their approach to asset allocation.

## DIVERSIFICATION 101

Diversification, simply put, is the act of combining uncorrelated investments—i.e., various asset classes and investment types that react differently to the same market conditions. As markets have evolved, diversification has emerged as an efficient way to address risk.

One of the preliminary ways to represent this idea was the style box. It analyzed the market capitalization (size) and investment style of US stocks, helping to show investors whether their portfolios were properly allocated. The style box showed, for example, that when small-caps outperform large-caps and growth is in favor versus value, you could reduce your overall risk by investing in multiple areas instead of being concentrated in one.

## ADD IN ADDITIONAL LAYERS

But why use only stocks? As asset classes emerged over the years—introducing new opportunities—portfolio construction began to include other investment types. Additional layers, such as high-yield bonds, floating-rate instruments and alternatives, helped investors-diversify their portfolios even further.

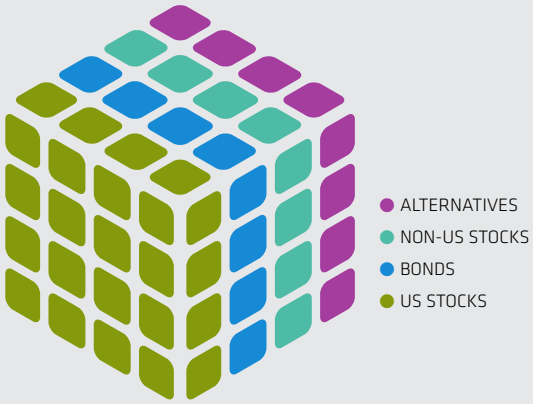
And because more than half of the investable assets in the world is found outside the US—and no country or asset class wins all the time—the addition of both international stocks and bonds became standard practice.

### DON'T PUT ALL YOUR EGGS IN ONE BASKET

| STARTING VALUE: $100 | YEAR 1 PERFORMANCE | YEAR 2 PERFORMANCE |
|---|---|---|
| Stock X | 45% | -20% |
| Stock Y | -12% | 35% |
| Stock Z | 10% | 10% |
| **Ending Value** | | |
| X = $116 | Y = $119 Z = $121 | **X + Y + Z= $124** |

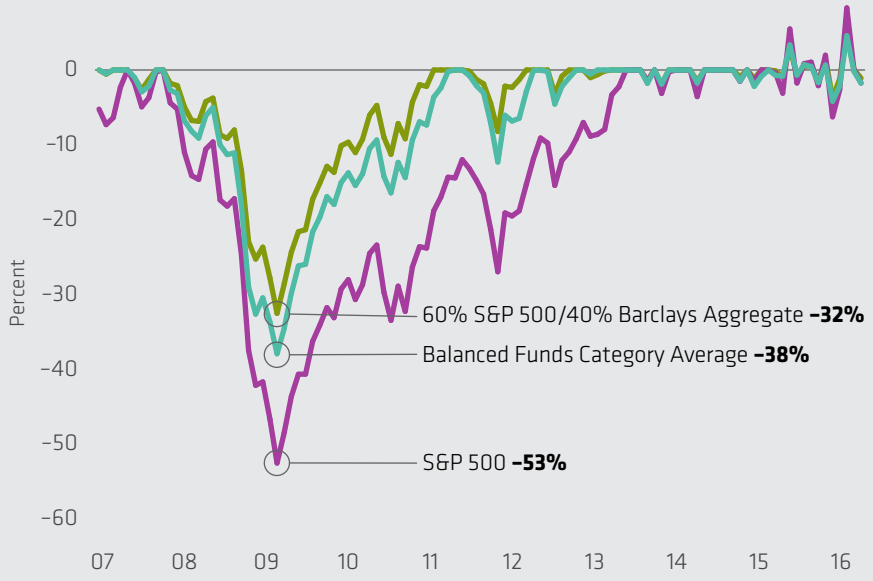
**This first step of diversification worked to improve return, but it still carried too much concentration.**

### BUILDING BLOCKS OF DIVERSIFICATION




**Through the turn of the century, the layering of alternative asset classes, such as REITS, commodities, long/short funds, market neutral, and private credit, added more opportunities to diversify risk and return sources.**

**THE 2008 FINANCIAL CRISIS CAUSED ASSETS TO MOVE IN UNISON**




**Past performance does not guarantee future results.**
Through December 31, 2016
Data points represent performance from January 1, 2007, through February 28, 2009.
Balanced funds represented by Morningstar Moderate Allocation category average
Source: Morningstar, Strategic Insight Simfund Mutual Fund Database, and AllianceBernstein

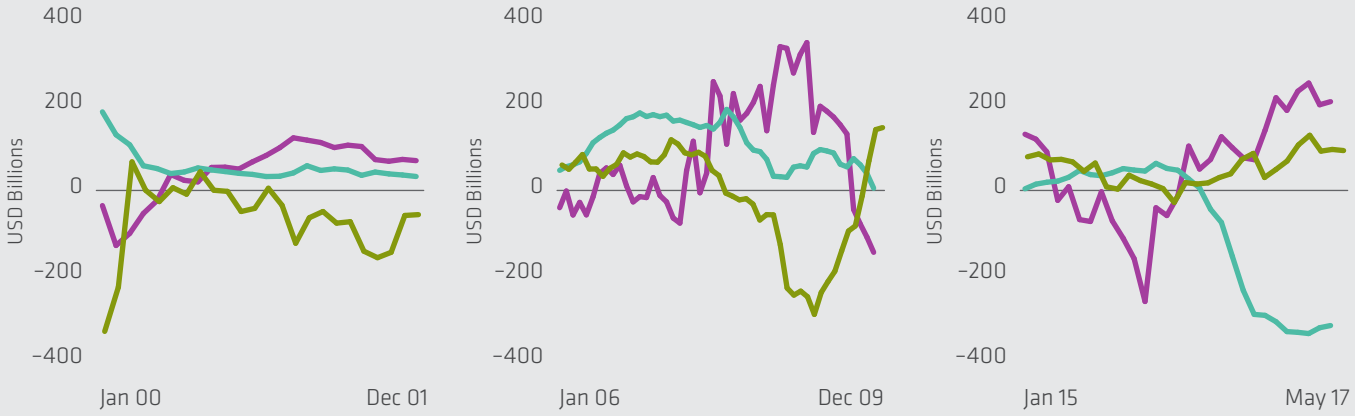
## PROBLEM: 2008 AND YOU

Then…2008. The global financial crisis. At the exact time when investors needed the diversification within their portfolios to provide a buffer against the market drawdown, it failed them. Correlations moved toward one, meaning that most investments moved in unison.

Investors couldn't rely on the usual portfolio defenders to counter the poor performers, because everything performed poorly. This taught our industry an important lesson. It's not just the act of being diversified that helps investors in the long term, it's how you employ that diversification.

But the approach to diversifying wasn't the only issue. Many investors reacted impulsively to the financial crisis, abandoning key investing principles. It's true that the financial crisis caused a record market decline, but since that time we've seen one of the strongest bull markets in history. However, many investors have stayed on the sidelines, haven't recouped their losses and haven't grown their retirement nest eggs.

**STOCKS HAVE REBOUNDED SINCE 2008, BUT INVESTOR BEHAVIOR HAS BEEN TROUBLESOME**
Historical S&P 500 Performance vs. Investor Flows



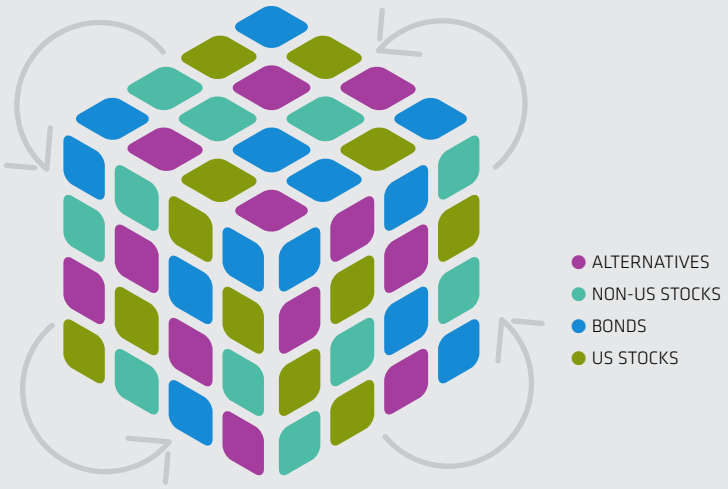

**Past performance does not guarantee future results.**
Through May 31, 2017
Source: Morningstar

## NEXT GENERATION DIVERSIFICATION

There's one important missing ingredient that can help investors navigate large market movements and keep their emotions out of portfolio decisions: flexibility. The ability to adjust the amount of portfolio exposure to a given asset class, sector, or geography can make a major difference to the bottom line. Asset allocation should not be a practice of "set it and forget it." Markets change and evolve, and so should your asset allocation.

The key is to allocate toward—and away from—investments based on the risk-and-reward impact. Most people wouldn't buy a ticket to travel to a country if it were experiencing dangerous conditions. Similarly, most investors wouldn't buy bonds of a country that is facing imminent default. Instead, they'd evaluate the risk-versus-return potential of a certain market segment, and adjust their exposure accordingly.

**FLEXIBILITY IS THE KEY TO PROPER DIVERSIFICATION**




## REFRAMING RISK

If posed with the question, "What's riskier, stocks or bonds?", most investors would immediately select stocks. But that doesn't take into account the full picture of investing. How do stocks and bonds stack up in addressing these dangers?

| | RISK FACTORS FOR STOCKS | RISK FACTORS FOR BONDS |
|---|---|---|
| Volatility | ● | |
| Savings Shortfall | | ● |
| Longevity | | ● |
| Inflation | | ● |

**Volatility Risk:** Certainly stocks are riskier than bonds. But volatility isn't the only risk investors face. There are more threatening hazards to the wealth of all pre-retirees and retirees.

**Savings Shortfall Risk:** When investors haven't saved enough, they are forced to seek outsized returns. Here, bonds are actually riskier than stocks because they can't supply the growth needed to fill that deficiency.

**Longevity Risk:** Approximately 30% of all 50-year-old women and 19% of all 50-year-old men will live to see their 90th birthdays. Bonds turn out to be a riskier investment because they can't supply the growth needed for retirees to spend a likely 30 years in retirement without a paycheck.

**Inflation Risk:** The decline in the purchasing power of a dollar over time can put your quality of life at risk. To help your money continue working hard for you over time, stocks should fair better than bonds.

## ADDRESSING THE RISKS FACING RETIREES

Many retirees are still unsure of how to address these headwinds. In a recent survey of 26,000 investors, 41% did not understand that a diversified portfolio was "a safer investment than a single stock," and 26% believed that a moderate investment should return over 16% annually. A remarkable 40% of respondents "did not know how inflation works," 38% said they did not understand the concept of compound interest, and 16% did not know if they should prefer a higher or lower interest rate on a mortgage.

Investors face countless risks today, especially as they prepare for retirement. While some asset classes are better than others at addressing specific risks, the bottom line is that investors need both proper asset allocation and proper asset location. There are many investment vehicles and solutions available to help investors properly diversify their risk and improve their chances for a successful retirement.

# LEARN MORE

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