

Portfolio Diversification's Radical Makeover

The concept of portfolio diversification isn't new, but it has recently been transformed. Only a decade ago, diversification meant holding large-cap domestic stocks, some bonds, and perhaps a small allocation to international equities. Given developments in portfolio construction theory and the current outlook for the world's investment markets, this strategy now seems inadequate.

Today, a fully diversified portfolio may contain additional investment vehicles and asset classes, such as structured investments, commodities, hedge funds, private equity, and real estate – investments that barely existed a decade ago or were available only to institutional investors and the very wealthy. In contrast, today's portfolio is diversified not only among different asset classes but also within asset classes. Instead of one large-cap equity manager, for example, several managers pursue different investment approaches.

The goals of portfolio diversification – to broaden an investor's access to sources of potential return while managing risk – haven't changed. But the application of this principle has been extended and refined. Here are some of the most significant changes in client portfolios.

Exposure to international equities

International stocks weren't the place to be in the 1990s, when the S&P 500 outperformed a diversified index of international stocks. However, international markets have outperformed U.S. equities for the last six years.¹

Addition of behavioral finance funds

Historically, most traditional equity managers relied on fundamental analysis. But studies have shown that, in some segments, it's becoming increasingly difficult to generate excess returns with this method. Behavioral finance is an alternative, and increasingly favored, method which maintains that psychological factors create biases, leading to irrational investment decisions. The goal is to take advantage of, and avoid, irrational investment behavior. Behavioral finance funds use quantitative, empirical models that observe how psychological factors affect stock prices.

Use of structured investments

These hybrid strategies combine long positions with derivatives that seek to help hedge risk and align investments with an investor's market views.

The active use of passive vehicles


In the past 10 to 15 years, new investment vehicles such as exchange-traded funds (ETFs) have come to the fore. A passive approach doesn't mean that these vehicles are limited to buy-and-hold investors; because many are transparent and liquid, investors can trade them actively to express particular investment views. This may potentially help enhance returns and reduce volatility.

Alternative investments

Alternative investments, including hedge funds, private equity, and commodities, have been gaining increasing acceptance among institutional and affluent investors, because they seek to provide low correlated portfolio diversification, some downside protection, and potential excess return. Of course, clients also must be mindful of the possible risks associated with such investments, including lack of liquidity and potential loss of capital.

Pulling it all together

In helping clients to manage their portfolios, JPMorgan aims not only to preserve, but also to grow wealth. As we have added more sophisticated strategies to our recommended equity and fixed-income allocations, it's consistently with these objectives in mind. The expanded toolkit at our disposal allows us to be more nimble in our portfolio construction, provides us with diversified sources that seek to generate excess returns, and should help to dampen the impact of a downturn in any single market segment.

Our portfolios today are positioned for efficiency and designed to seek better returns and lower volatility than those of 10 years ago. Thanks to portfolio diversification's recent radical makeover, our clients' portfolios can be better poised to address the challenging markets we are likely to encounter. 



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¹Source: J.P.Morgan Securities, Inc., MSCI, Bloomberg. Data as of 12/31/2007.