CAMBRIA

The Bear Market in Diversification

"Investing goes off track when you believe you are entitled to high returns because you did all the right things."

- Aswath Damodaran

First, a warning.

If you're an investor or, even worse, a financial advisor with a globally diversified portfolio, you may want to stop reading now.

Continuing may just be too painful.

We should form a support group for investors who built low-cost, tax-efficient, globally diversified portfolios across stocks, bonds, and real assets. These investors rebalanced their portfolios and didn't waver when COVID hit the fan.

And despite all that well-researched and thoughtful implementation, they got steamrolled by the S&P 500.

The following phrases may bring out some PTSD. (Maybe a better acronym would be GAASD for Global Asset Allocation Stress Disorder.)

Raise your hand if you muttered any of the following phrases to yourself. For the financial advisors out there, this list is probably just the beginning…

- "Can you explain why we own foreign stocks? All they do is underperform. China is down 60%!"
- "Why do we hold Gold? Ok, Boomer…"
- "Everyone knew investing in bonds at 1% was a dumb idea, why didn't you?"
- "I read recently that GDP was going to accelerate to 50% a year due to AI. Can we sell all these underperforming value funds and buy QQQ and NVDA?"
- "This portfolio is much more volatile than my neighbor's – he's in private equity and real estate, and it moves WAY less…"

I could go on, but it would just be cruel.

You know all this because you lived through "The Bear Market in Diversification".

What exactly do we mean by that?

In 2015, our CIO, Meb Faber, wrote the book *Global Asset Allocation: A Survey of the World's Top Asset Allocation Strategies*.

The book examined various asset allocation portfolios and their performance from 1973 – 2013. While most of the portfolios had returns similar to those of the US stock market, they also featured lower volatility, drawdowns, and a higher Sharpe ratio than just sitting in the S&P 500. It didn't matter what specific allocation was chosen; they all did a pretty good job smoothing out the rocky ride that was the US stock market.

So, let's say you read Meb's book and decided to invest with a global asset allocation model as your guide.

Then things got tough.

The tough times began in the aftermath of the Global Financial Crisis. Stocks declined by over 50% during the GFC, causing

many investors to panic and capitulate. The most bearish readings ever on the AAII survey occurred at the bottom in March 2009. For many years after the GFC, we spoke to investors who proclaimed, “I couldn’t take it anymore and sold everything; I’m still in cash and just too scared to get back in.”

Unfortunately for these shell-shocked investors, stocks have RIPPED since March 2009, compounding at 15% per annum through 2023.

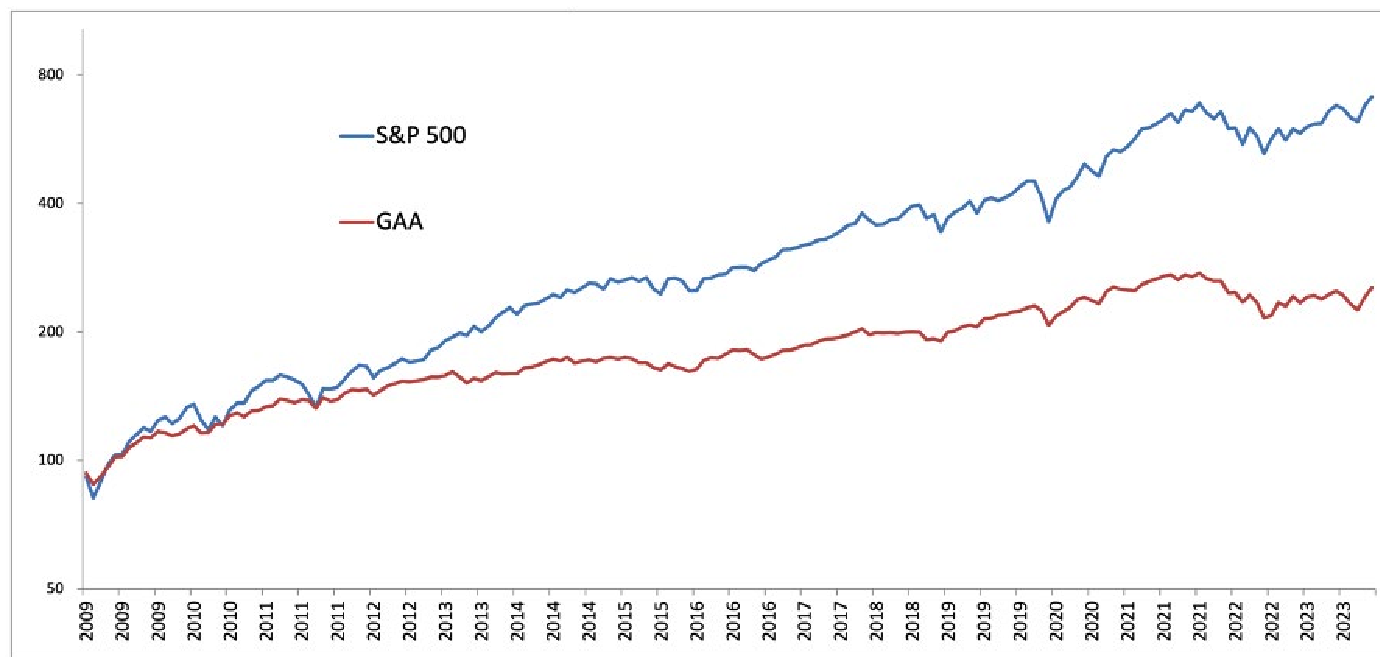
Let’s examine how various asset allocation strategies performed from 2009 to 2023 (we’ll use 2008 as the year-end for simplicity). The exact allocations are in our free Global Asset Allocation (GAA) book.

As you already know, the S&P mowed down everything. Whether you followed the global market portfolio (GAA), the All Seasons portfolio from Dalio and Robbins, or the Endowment style portfolio from El-Erian and Swensen, they all underperformed the mighty S&P.

From 2009 to 2023, most asset allocation portfolios had reasonable returns of 6-7% a year. The S&P doubled those returns to 13.9% per year. (Again, this 13.9% is slightly lower than the 15% from the March 2009 bottom.)

Adding insult to injury, all the allocations had similar drawdowns and worse Sharpe Ratios than US stocks. Volatility was lower, but not in a good way since most of the volatility for US stocks came from upward “we’re getting rich” volatility.

Exhibit 1 - S&P 500 vs. GAA Allocation, 2009-2023



Source: Global Financial Data

Still, 6-7% returns are respectable.

Why, then, was this such a challenging period for diversification?

Let’s use the GAA allocation for reference. Despite putting up returns in line with historical averages of almost four percentage points above inflation, the allocation underperformed the S&P 500 by over seven percentage points per year.

But that's not the punchline.

The globally diversified portfolio didn't just underperform by a significant amount per year; it underperformed nearly EVERY year.

That's a significant distinction. Investors can handle underperforming for a year or two, but the constant struggle crushes morale, causing many to give up.

The GAA portfolio underperformed ten years in a row.

Not one, not two. TEN.

And if we go back further, the GAA portfolio underperformed in 13 of the past 15 years. The only period remotely comparable was the post-WWII era.

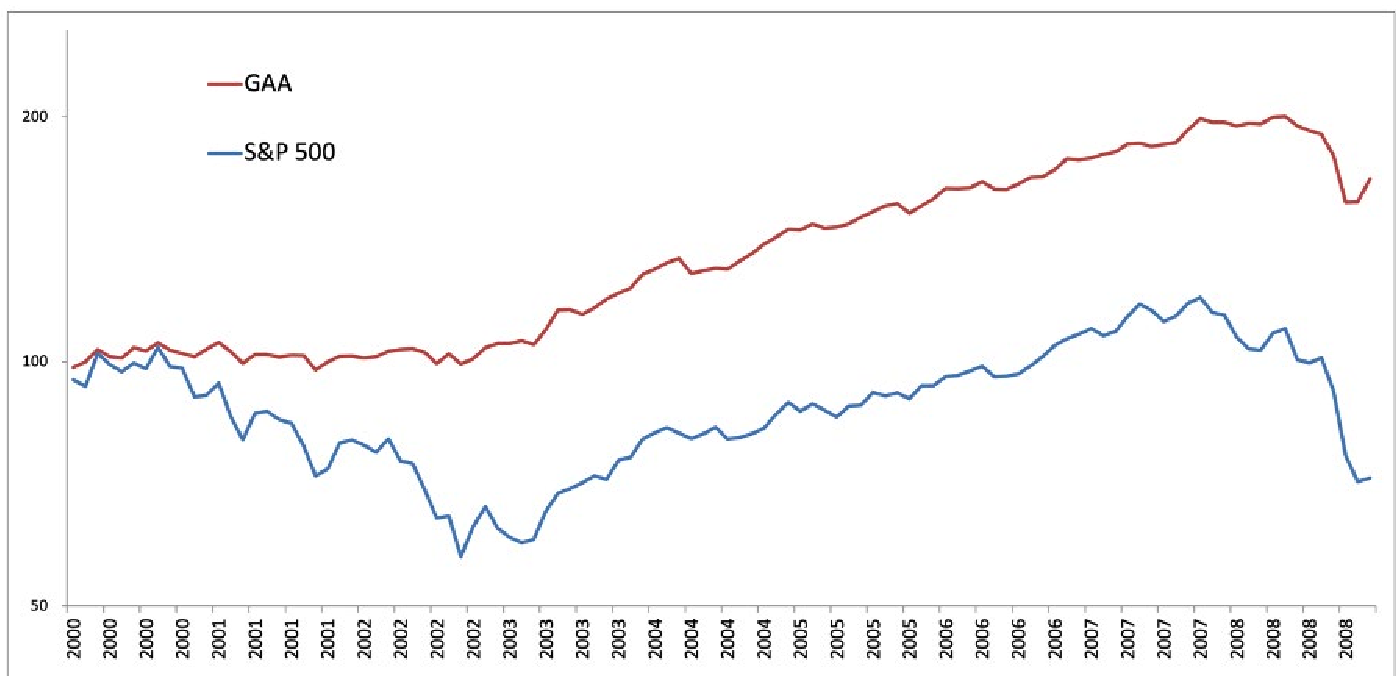
No wonder your clients think the game has passed you by.

As Charlie Munger said, "The world is not driven by greed. It's driven by envy." Watching your portfolio lose out to a basic ETF like SPY year after year takes a toll.

This piece targets US investors, but if you're one of the 95% of humans living outside the United States, diversification works excellent! That's mainly because you would have invested about half of your stock exposure in US stocks...

However, if you rewind to the period from 2000 to 2008, everything looks a lot different. GAA outperformed US stocks, and it did it with lower volatility, lower drawdowns, and a higher Sharpe ratio.

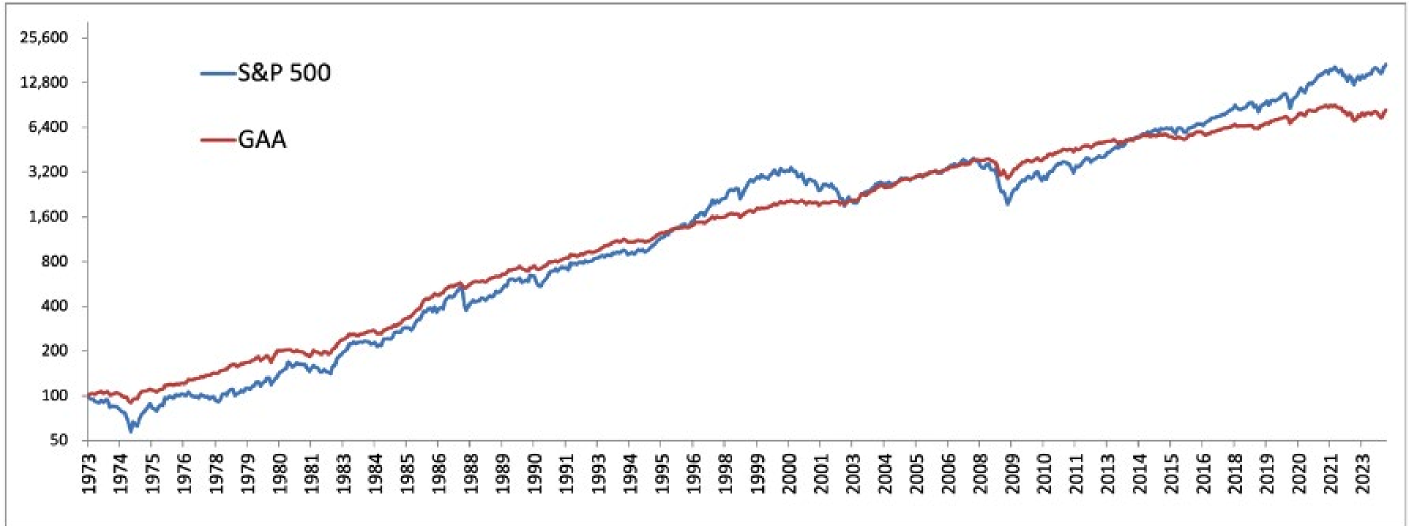
Exhibit 2 - S&P 500 vs. GAA Allocation, 2000-2008



Source: Global Financial Data

Below, we zoom out to the whole picture.

Exhibit 3 – S&P 500 vs. GAA Allocation, 1973-2023

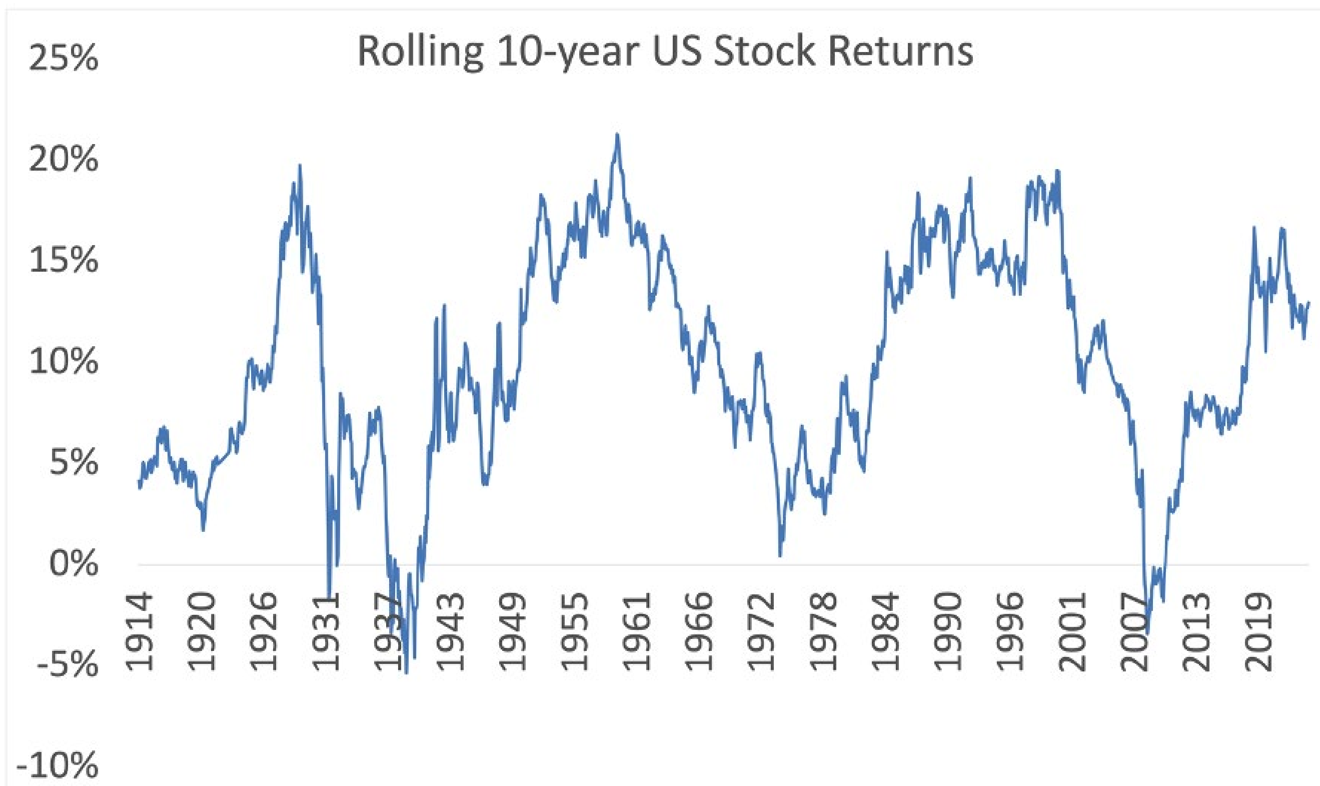


Source: Global Financial Data

The problem is deciding when or even if this trend will reverse. This article, for instance, could easily have been written in 2021, with similar gripes and conclusions.

Let's consider the 15% S&P 500 returns for over a decade in the context of history. Below is a chart of rolling 10-year US stock returns for the past 100+ years. Four periods have been similar in performance.

Exhibit 4 - Rolling 10-Year US Stock Returns 1914-2023



Source: Global Financial Data

Are these sky-high returns “normal”? Sure, these returns fit well within what has happened in history. The other three times this happened all have names...

- The Roaring Twenties
- The Nifty Fifties
- The Internet Bubble
- and whatever we are going to call this period – likely the COVID memestonk era

The problem is eventually, the good times end. Unfortunately, those all had names too.

- The Great Depression
- The Inflationary 70s
- The Internet Bust and Global Financial Crisis
- ... and, whatever comes next

None of the above means stocks have to crash. The broad US stock market is expensive, but it’s not as ridiculous as a few years ago or at the peak of the Internet Bubble. Still, this is a richly valued market.

So, what’s an investor to do? Go all in on SPY? QQQ? Forsake the globally diversified portfolio for the allure of a different boat?

If you follow Cambria and our writings, you likely know our answer, which will stay consistent across market cycles.

- Diversify globally using stocks, bonds, and real assets
- Implement the allocation with low-cost tax tax-efficient ETFs
- Rebalance the portfolio consistently
- Tilt towards factors like value and momentum
- Add a healthy slug to trend following too

Are you willing to bet the past 15 years continue? If it does and you are diversified, you’ll still be OK. If not, that’s a problem. 2022 was a good reminder that stocks and bonds don’t always go up. What if we have multiple years like that?

We’re reminded of a quote from the great Sir John Templeton:

“Diversification is a safety factor that is essential because we should be humble enough to admit we can be wrong.”
– John Templeton.

Because we never know when or what is coming next.

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