While it's true that diversification is immensely valuable, helping to boost risk-adjusted return potential and allow for smoother portfolio growth, the truth is that diversification is not entirely free. (UBS)

Performance-chasing is dangerous

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Our brains are hardwired to find patterns, even in random noise. We also have a strong recency bias that leads us to favor newer information over older information. Together, these tendencies lead to performance-chasing behavior that leads us to get caught up in mania and panics

This performance-chasing tendency is one driver of the "value factor": Over most long-term periods, and in most markets, cheaper stocks tend to outperform expensive stocks, especially on a risk-adjusted basis. Cheap stocks rarely inspire the same excitement as "growth" stocks (companies with the highest expected growth). In a notable example of recency bias, it currently feels like the obvious way to invest is to over-allocate to high-growth US stocks such as the so-called Magnificent 7. These stocks rallied 107% last year, and there is a solid story behind their profit growth outlook. At the same time, many investors may have forgotten that these same stocks lost 45% in 2022, when the S&P 500 lost only 18%.

Valuation may not lend itself to a satisfying story, but (on average, and all things being equal) cheap valuations help to indicate better forward-looking returns. By the same token, even a well-run company can become a bad investment if its valuation already reflects its full long-term potential. To quote Warren Buffett, "you can turn any investment into a bad deal by paying too much."

Today, the Magnificent 7 trade at 30 times last year's earnings, nearly twice as expensive as the other 493 S&P 500 stocks' 18.5x price-to-earnings ratio. At the very least, the Magnificent 7 stocks' extended valuations will be a long-term headwind to their returns. There is also a risk that some of their expected profit growth may not come to pass (due to competition, geopolitical risks, and other variables). Chasing performance can be dangerous for investors. Looking at the annual returns of 14 major asset classes since 1999, last year's best-performing asset class has had a roughly 40% chance of experiencing a loss this year, versus 27% for a randomly chosen asset class and 31% for a well-diversified portfolio.

More than the sum of its parts

Globally diversified portfolios allow you to participate if one asset class or set of stocks does particularly well, while remaining resilient against the risk—or rather, the inevitability—that markets will “rotate” away from the recent frontrunners in favor of the recent laggards.

When you are able to embrace the boring nature of your diversified portfolio's returns, it becomes far easier to set and calibrate expectations around performance (as opposed to the relative randomness of individual asset classes' returns). Better performance expectations, in turn, are one of the best ways to manage the feeling of discomfort; after all, a lot of discomfort comes from the difference between expectations and reality.

Moreover, when you focus on managing the overall investment strategy, rather than obsessing over the performance of its parts, it becomes much easier to resist the temptation to fine-tune the portfolio's individual pieces in response to recent returns.

Discomfort is an inherent characteristic of how diversification works:

- Diversified portfolios are constructed using asset classes that are driven by different underlying forces, so they aren't perfectly correlated with one another.
- Non-correlated investments' returns wax and wane at different times, so the effect of extremely strong returns in one asset class will be tempered by modest (or even poor) returns in another part of your portfolio.
- This interaction reduces portfolio risk per unit of return, allowing the portfolio to enjoy a smoother path of growth —a better risk-adjusted return.

While it's true that diversification is immensely valuable, helping to boost risk-adjusted return potential and allow for smoother portfolio growth, the truth is that diversification is not entirely free; to harvest diversification's benefits, you must pay an entry fee: discomfort.

For the full report see: **Diversification is uncomfortable,** 14 March, 2024.

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