

Keys to Successful Diversification

By Andrew Menachem

If your investment portfolio consists solely of shares in one geographic locale, such as your Florida company's stock, you're making a high-risk bet on your future. If the company suffers a downturn or goes out of business, those once-valuable shares could plummet in value.

That's why financial advisors typically recommend building a more diversified portfolio that may include shares in multiple companies, mutual funds, bonds, and cash with some alternative assets to round out the mix.

Diversification is one of the fundamentals for potentially successful long-term investing because it can help stabilize your portfolio and reduce risks. If you own real estate, commodities or other types of alternative assets, along with a mixture of stocks and bonds, a drop in the financial markets may not be quite as damaging.

While the basic concept of diversification is easy to understand, putting this strategy to work can be a bit of a challenge and it can prove unsuccessful. That's because effective diversification involves more than looking at a menu of asset choices and picking two or three that sound appealing.

The key to successful diversification is understanding, which assets typically rise and fall in value at the same time – a concept called correlation. For instance, at times, U.S. and international stocks can be highly correlated, producing both positive and negative returns at the same time. That was certainly the case in the 2008 financial meltdown, when both stock and bond prices plummeted.

But there are alternative assets that may rise in value, or may at least hold their own, when Wall Street takes a tumble. These include private equity funds, hedge funds, commodities and managed futures. Therefore, including some alternative investments in qualified investors' portfolios may help reduce volatility.

A number of market studies indicate that managed futures may provide an effective way to balance a portfolio.

Let's take a closer look at managed futures as an investment class, which has deep roots in American history. Decades ago, farmers, ranchers and bankers sought a way to help reduce the price swings in the agricultural markets. The result was the concept of a futures contract, which set a certain delivery price in advance for a specific commodity.

As the potential advantages of this risk management strategy became more apparent, the concept of the futures contract was extended to the foreign exchange and interest rate markets in the 1970s and '80s. Since then, the future markets have continued to grow and play an important role for many investors.

Today, a managed futures fund is guided by a manager called a commodity trading advisor (CTA) who can follow different strategies in six major market sectors: agricultural products, currencies, energies, interest rates, major metals and stock indices.

Although not suitable for all investors, managed futures afford a limited opportunity to participate directly in these markets, such as crude oil, Japanese debt or foreign exchange relationships. Therefore, managed futures offer the benefit of exposure to these markets at a certain level yet investors should appreciate that futures are speculative, illiquid investments subject to less regulatory standards, special tax treatment and conflicts of interest.

Underlying futures markets can be driven by different factors than those influencing stock and bond prices. That alone may reduce the correlation. In addition, the CTAs can make potentially profitable investment decisions regardless of whether the markets are moving up or down. So even when Wall Street is having a bad year, managed futures may still show a positive return.

On the other hand a good year for stocks and bonds can result in negative returns for managed futures.

Since 1980, there have been six times when the S&P 500 Index has fallen by 10 percent or more. In each case, managed futures, as measured by the Barclay CTA index, produced positive returns. In 2008, for instance, managed futures were up 14.4 percent while the S&P was down 36 percent. .

For a qualified investor, managed futures holdings might be somewhere between 3 and 10 percent when combined with other asset classes. Historically, that allocation has been shown to improve both the overall portfolio diversification and the risk-adjusted return. So managed futures can be an effective diversifier within a properly diversified portfolio. It's important to know, however, that this strategy may not prove successful. .

In any case, be sure to consider the many potential advantages of diversification and suitability when talking with your financial advisor about your investments for the future.

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