CLEARWATER CAPITAL

Thought Leadership

THINK18

April 2018

Portfolio Insights

The Merits of Diversification

Recently, the merits of diversification have been debated as investors have scrutinized the outperformance of the S&P 500 compared to other asset classes since 2013. This has left investors asking the question, "Why not concentrate my holdings in an S&P 500 Index fund?"

This question has been posed over time, while the asset class in question has changed. We can look back to the late 1990's when tech stocks were the rage, and it appeared wise to invest only in tech stocks. Many investors became so captivated with tech stocks that they abandoned the time-tested disciplines of asset allocation.

1)

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	YTD	2000 - 2015 Ann.	2000 - 2015 Vol.
Comdty. 31.8%	REITs 13.9%	Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	EM Equity 14.8%	REITs 12.0%	EM Equity 25.4%
REITs 26.4%	Fixed Income 8.4%	Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	REITs 14.0%	High Yield 7.9%	REITs 22.0%
Fixed Income 11.6%	Cash 4.1%	High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	High Yield 13.6%	Small Cap 6.6%	Small Cap 21.2%
Cash 6.1%	Small Cap 2.5%	REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Small Cap 10.2%	EM Equity 5.9%	DM Equity 19.6%
High Yield 1.0%	High Yield 2.3%	Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	Large Cap 7.8%	Asset Alloc. 5.6%	Comdty. 18.7%
Asset Alloc. 0.0%	EM Equity -2.4%	Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	Asset Alloc. 7.0%	Fixed Income 5.4%	Large Cap 16.7%
Small Cap -3.0%	Asset Alloc. -3.9%	EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Fixed Income 5.9%	Large Cap 4.1%	High Yield 11.5%
Large Cap -9.1%	Large Cap -11.9%	DM Equity -13.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Comdty. 5.6%	DM Equity 2.8%	Asset Alloc. 11.2%
DM Equity -14.0%	Comdty. -19.5%	Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.8%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 0.9%	Cash 1.8%	Fixed Income 3.4%
EM Equity -30.6%	DM Equity -21.2%	Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.2%	Comdty. 0.8%	Cash 1.0%

Source: JPMorgan Asset Management, see page 4 for additional disclosures

This resulted in concentrated exposures in this single asset class and a most unfortunate outcome when the tech bubble eventually burst in March of 2000. There are countless examples over time when this pattern of short-sighted thinking takes hold and investors repeat this mistake. A longer-term perspective is imperative to objectively evaluate the merits of diversification.

The data set shown above presents annual year returns for a variety of major asset classes over the past fifteen years. Also represented is a somewhat traditional diversified portfolio. While the S&P 500 (shown in green) has recently outperformed a diversified portfolio (shown in white), the outperformance is sporadic from year to year.

Tyler J. Beachler,

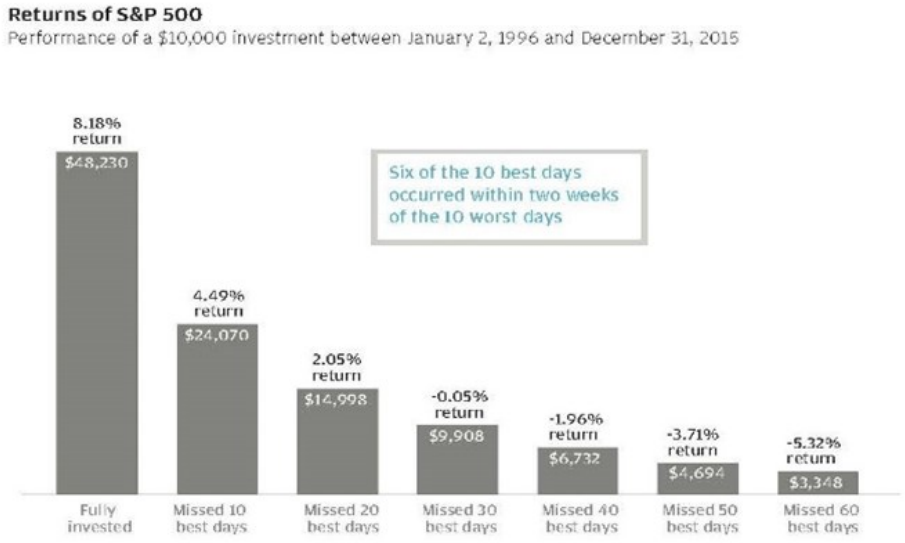
Tyler J. Beachler, CIMA® is the Senior Analyst and Operations Manager leading the firm's service excellence efforts and analytical capabilities to provide quality and efficiency in support of clients. Tyler is also a member of the firm's Investment Policy Committee where his analytical insights help form Clearwater Capital Partner's investment strategies.

Equally important is the fact that the diversified portfolio has significantly reduced the volatility when compared to that of the S&P 500. In fact, the variability of returns (as measured by standard deviation) is an important consideration in portfolio construction. All-things-being-equal, an investor would prefer to experience the highest possible return with having exposure to the least amount of risk.

Over the 15 years of data presented in this table, we see that the diversified portfolio enjoyed average annual returns that were higher than the S&P 500 asset class and with less volatility over this same period of time.

A study known as "Determination of Portfolio Performance" by Brinson, Hood, and Bebower was first published in the Journal of Finance in 1986. The study examined data from 91 large pension funds over a 10 year period and found that portfolio performance was explained by three primary factors: asset allocation, market timing, and security selection. Remarkably, the study observed that roughly 93% of the variance between returns was explained by asset allocation. The factors of market timing and security selection were of relatively little importance when it came to long-term results. Simply put, performance is driven primarily by asset allocation decisions.

Market timing is a risk-on, risk-off approach of active management wherein the attempt to time the ups and downs of the market is hoped to lead to superior returns. To succeed, the active manager must be right twice, knowing when to get out and when to get back in. Charles Ellis, in his book "Winning the Loser's Game", comes to the conclusion that there is no empirical evidence indicating that market timing consistently adds value. In fact, the effects of missing the best days can severely impair total returns over time, as shown below.



PLAN TO STAY INVESTED

Trying to time the market is extremely difficult to do consistently. Market lows often result in emotional decision making. Investing for the long term while managing volatility can result in a better retirement outcome.

2) Source: JPMorgan Asset Management, see page 4 for additional disclosures

Security selection, also commonly known as stock picking, is the other cornerstone of active management. Here once again the research does not indicate these techniques are beneficial. Twice each year S&P Dow Jones Indices publishes a report entitled The SPIVA® Scorecard. The report analyzes the success of active

managers selecting stocks to deliver outperformance relative to appropriate benchmarks.

The results of this analysis shows that the vast majority of active managers, in almost every single asset class, fail to consistently outperform their benchmarks over 1, 3, 5, and 10 year periods. While it may be possible for some managers to add value through security selection over short periods of time, security selection over the long-run appears more likely to detract from total returns than to add.

The combination of these, and other, studies lead BSC Private Wealth Management to focus primarily on asset allocation decisions in order to achieve proper portfolio strategies for our clients.

IMPORTANT DISCLOSURES

Chart Sources/Disclosures:

1) Source: Barclays, Bloomberg, FacSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. Large Cap: S&P 500, Small Cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays Global HY Index, Fixed Income: Barclays Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/99—12/31/15. All data represents total return for stated period. Past performance is not indicative of future returns. Guide to the Markets—U.S. Data are as of August 31, 2016

2) This chart is for illustrative purposes only and does not represent the performance of any investment or group of investments. Source: J.P. Morgan Asset Management analysis using data from Morningstar Direct. 20-year annualized returns are based on the S&P 500 Total Return Index, an unmanaged, capitalization-weighted index that measures the performance of 500 large capitalization domestic stocks representing all major industries. Past performance is not indicative of future returns. An individual cannot invest directly in an index. Data as of April 2018