NOTTINGHAMADVISORS
ASSET MANAGEMENT

DIWORSIFICATION

"As a standing rule, it may be taken that the stock market is always many months ahead of business conditions and is moved by the sum of everybody's real knowledge."

-William Peter Hamilton, Editor, WSJ, 1919

Diversification in one's investment portfolio is often touted as the only "free lunch" in investing. The idea that by adding multiple non-correlated asset classes or exposures to one's portfolio, one can reduce volatility and enhance portfolio return, is the cornerstone of modern portfolio theory (MPT). It's the framework around which all of the portfolios crafted at Nottingham Advisors are built.

Lately, however, one could be forgiven for questioning the virtues of diversification, Nobel Prize for MPT notwithstanding. For the second year in a row, the S&P 500 has clearly outpaced most other asset classes and equity sub-sectors, leaving many a client to wonder just exactly why they own anything other than the S&P 500.

The phrase that is the title to this missive was first coined by the legendary investor Peter Lynch. He used it to describe what happened to a business that expanded too aggressively away from its core competence, thereby damaging the original enterprise and hence subsequent returns for its shareholders. The natural corollary in our case follows that overly-enthusiastic diversification <u>may</u> have a deleterious long-term impact on one's investment portfolio return.

Nottingham has long worshipped at the altar of MPT, touting the many virtues of holding a diversified investment portfolio tailored to a specific risk profile. The strong recent returns of the S&P 500, however, have forced us to, perhaps not *reconsider*, but merely take a good hard look at our models and asset mix, and ask ourselves, are we are adding value by including multiple non-correlated exposures?

I'll spare you the suspense, as the answer to the question is <u>YES</u>. I could list the myriad reasons for you; however, I feel it's better explained by the chart on the following page. The so-called "quilt chart" is an oft-used vehicle that clearly and colorfully illustrates the randomness of asset class returns over time. There is no consistent identifiable pattern at first glance (if YOU see one, please call me immediately as you may be on to something big!), aside from the relatively steady returns of the Diversified Portfolio (yellow).

A more detailed analysis reveals a couple of things. First, emerging market equities have done quite well over the past decade – or quite poorly. In 7 out of the 10 periods, EM equities were either first or last. That, my friends, is a good definition of volatility. Secondly, large U.S stocks (gray), while trumping international developed market equities (blue) the past two years have actually underperformed their foreign counterparts exactly half the time. That's pretty close to a coin flip, huh?

The quilt chart is a none-too subtle reminder that asset class returns can be random over time.

2005	2006	2007	2008	2009	2010	2011	2012	2013	YTD 2014
Int'l EM Stocks 34.0%	Int'l EM Stocks 32.1%	Int'l EM Stocks 39.4%	Core Bond 5.2%	Int'l EM Stocks 78.5%	Small U.S. Stocks 26.6%	Core Bond 7.8%	Int'l EM Stocks 18.2%	Small U.S. Stocks 38.6%	Real Estate 25.7%
Commodities 17.5%	Real Estate 28.3%	Int'l Dev. Stocks 11.2%	Cash 2.4%	Int'l Dev. Stocks 31.8%	Real Estate 21.8%	Real Estate 2.4%	Int'l Dev. Stocks 17.3%	Large U.S. Stocks 32.0%	Large U.S. Stocks 14.1%
Int'l Dev. Stocks 13.5%	Int'l Dev. Stocks 26.3%	Commodities 11.1%	**Diversified Port. -27.1%**	Small U.S. Stocks 26.7%	Int'l EM Stocks 18.9%	Large U.S. Stocks 2.1%	Small U.S. Stocks 16.3%	Int'l Dev. Stocks 22.8%	**Diversified Port. 5.9%**
Diversified Port. 7.9%	Small U.S. Stocks 18.2%	**Diversified Port. 7.7%**	Small U.S. Stocks -33.6%	Large U.S. Stocks 25.9%	Commodities 16.7%	Cash 0.1%	Large U.S. Stocks 15.9%	**Diversified Port. 17.1%**	Core Bond 5.4%
Large U.S. Stocks 4.8%	**Diversified Port. 15.7%**	Core Bond 7.0%	Large U.S. Stocks -36.6%	**Diversified Port. 24.2%**	Large U.S. Stocks 14.8%	**Diversified Port. -1.7%**	Real Estate 15.0%	Cash 0.1%	Small U.S. Stocks 1.9%
Small U.S. Stocks 4.4%	Large U.S. Stocks 15.6%	Large U.S. Stocks 5.6%	Commodities -36.6%	Real Estate 19.9%	**Diversified Port. 12.6%**	Small U.S. Stocks -4.2%	**Diversified Port. 12.4%**	Real Estate -1.2%	Int'l EM Stocks 0.6%
Cash 3.1%	Cash 4.8%	Cash 5.0%	Real Estate -41.0%	Commodities 18.7%	Int'l Dev. Stocks 7.8%	Int'l Dev. Stocks -12.1%	Core Bond 4.2%	Core Bond -2.0%	Cash 0.1%
Real Estate 2.5%	Core Bond 4.3%	Small U.S. Stocks -1.5%	Int'l Dev. Stocks -43.4%	Core Bond 5.9%	Core Bond 6.5%	Commodities -13.4%	Cash 0.1%	Int'l EM Stocks -2.6%	Int'l Dev. Stocks -2.0%
Core Bond 2.4%	Commodities -2.7%	Real Estate -21.4%	Int'l EM Stocks -53.3%	Cash 0.3%	Cash 0.2%	Int'l EM Stocks -18.4%	Commodities -1.1%	Commodities -9.6%	Commodities -10.8%

Through 12/03/14, Total Return, Large U.S. Stocks = S&P 500, Small U.S. Stocks = Russell 2000, Int'l Developed Stocks = MSCI EAFE, Int'l EM Stocks = MSCI EM, Core Bond = Barclays Aggregate Bond, Cash = BofAML U.S. Treasury Bills, Real Estate = FTSE NAREIT All-REITs, Commodities = Bloomberg Commodity, Diversified Port. = 30% Large U.S. Stocks, 10% Small U.S. Stocks, 20% Int'l Dev. Stocks, 6% Int'l Emerging Stocks, 25% Core Bond, 3% Cash, 3% Commodities, and 3% Real Estate

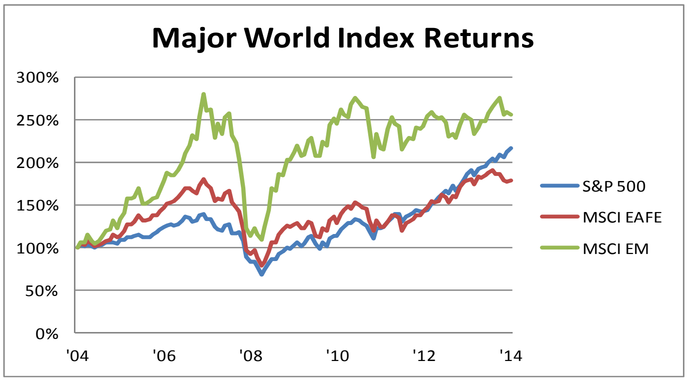
A final observation from the above is that the diversified portfolio (yellow) shows the most consistency over time from a return perspective. Bonds and cash represent a drag on performance in strong equity years; however, they provide ballast in years when things don't go so well (see 2008). I would challenge anyone to come up with an accurate ordering of 2015's returns. If you can do that, then simply buy the asset class you believe will do best and avoid (or short) the laggards. Aside from realizing a strong return next year, you would also become a truly unique investor, likely landing yourself a profile in the WSJ as the only investor in the world to make such an accurate forecast. Absent that ability, it would seem to us that it makes more sense to diversify!

Anchoring

So-called "anchoring" is a well documented behavioral bias that causes investors to latch on to meaningless or irrelevant statistics, and use those figures as the basis for judgment. An example might be an investor with a globally diversified portfolio using the Dow as an investment benchmark and basing future decisions on whether he/she was ahead or behind that benchmark. If the Dow returned 12% last year but the investor's portfolio only returned 6%, the investor would be highly disappointed. Likewise, say he/she outperformed the Dow by 700 basis points, they'd likely be feeling pretty good.

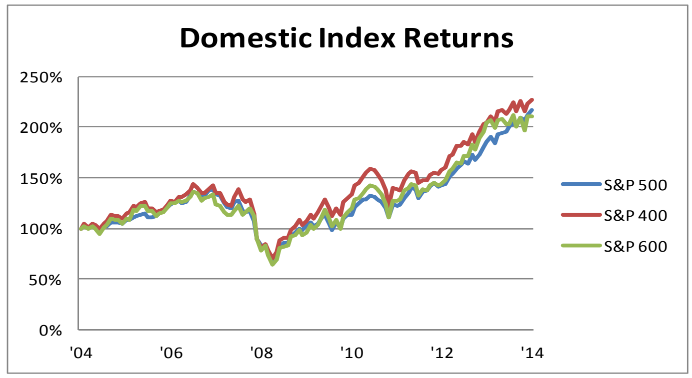
What's missing in this example is the fact that the Dow is a terrible benchmark for this investor with a globally diversified portfolio. A price-weighted basket of 30 US large cap stocks is not representative of the global investable market. This very same behavioral bias has globally diversified individuals comparing their 60/40 stock/bond mix with the S&P 500 in 2014 and questioning why they're trailing by 500 bps. Forgotten amidst the *sturm und drang* are the tremendous benefits the investor has realized over time from owning a diversified asset mix.

If the above quilt chart weren't enough to convince you that asset class returns are random over time, perhaps we should examine a couple periods where things weren't so rosy for the S&P and where international diversification bore fruit.

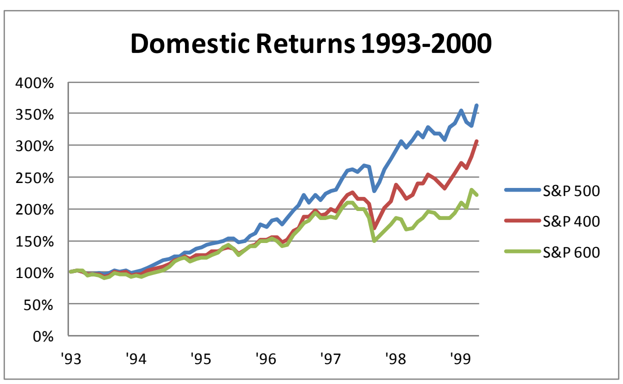


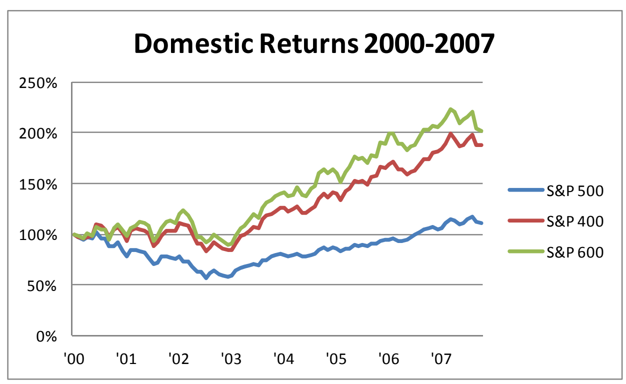
Despite their inconsistency, emerging market equities have clearly outperformed both US and international developed market stocks over the past decade. Much of this was driven by higher growth rates in China, India, Brazil and Russia. With that higher return comes significantly higher volatility, which can be muted by accepting longer holding periods. EM equities appear fairly valued heading into 2015.

Domestically, mid-caps have eked out a small advantage over small and large-caps over the past decade. Again, higher volatility accompanies these higher returns. Small caps have historically returned more than large caps, primarily due to the higher risks associated with stocks with lower market capitalizations. What is true historically, however, often doesn't hold up over short to intermediate periods of time.

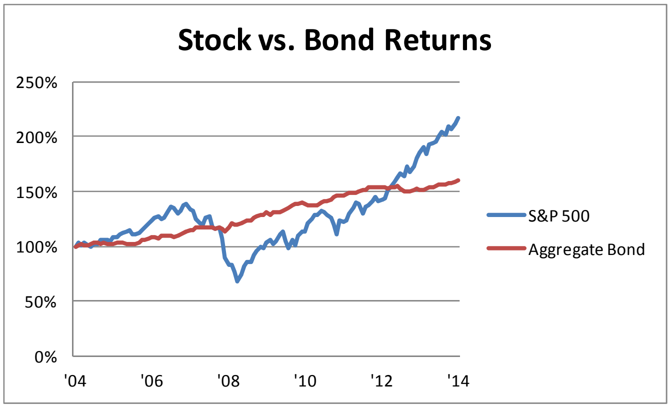


Given the ups and downs of the past decade, it's easy to forget the go-go '90's. This was the advent of the internet and nearly every computer-related company saw stratospheric valuations, with IPO's of tech companies doubling and tripling in value on their launch. It truly was a time of "irrational exuberance" as former Fed chair Alan Greenspan commented. It was also a good example of how investors focused only on one area of the market can make, or lose, a lot of money. You just need that crystal ball to show you exactly which asset class will outperform, and for how long. Easy, right?





We all know how the 1990's tech bubble ended – badly. Large-cap growth companies struggled mightily from 2000-03. This was just the beginning, however, of a great bull run in small and mid-cap companies, which had largely been ignored the prior decade. Many non-diversified investors missed out completely on this shift in investor sentiment, or joined the party much too late. This happens all the time by the way. The rear-view mirror is very accurate, but it's a horrible way to invest for tomorrow. As the quote leading off this note implies, the stock market has always been, and likely always will be a forward-discounting mechanism, incorporating tomorrow's news into today's prices.



Finally, remind me why I own those low-yielding bonds again? Well, they served you pretty well in 2008-09 and my guess is they'll serve you well again the next time the market decides to riot. Long time horizons and high risk tolerances can obviate the need for such ballast. However, few investors we've come across have these traits to the degree necessary. That which represents an opportunity cost one day can save the portfolio the next.

Conclusion

As 2014 winds down, we find the US economy entering year 6 of a slow but steady recovery following the Great Recession of 2008. Typical expansions last around 7 years and it would be disingenuous of us to suggest we're in anything but the middle to later stages of this growth cycle. As suggested earlier, US corporate earnings remain solid, profit margins near peaks and investor sentiment robust. Price-earnings multiples are a bit stretched, but certainly could move higher. International equities are cheap – but for a reason: growth is scarce and deflation a real threat. Bonds globally are uninteresting, but necessary.

Lower energy prices should be the great catalyst for extending this economic expansion well into 2015 and beyond. It should aid manufacturers, especially those companies with high fixed power costs, as well as the consumer, who will see drastically lower prices at the pump, airline tickets and home heating bills. The US consumer still accounts for about 70% of US GDP and the impact of $60 oil could add a full percentage point to 2015's growth rate. Low energy costs and low interest rates make for a very low hurdle rate for both consumers and corporate America alike to engage in productive activities.

International equities should rebound in 2015 as Germany and Japan both reap the benefit of increased QE and lower energy import costs. We're cautiously optimistic that Europe can stave off deflation and return to 2%+ GDP growth over the next year or two. Japan too should see continued growth as the Yen continues its decline. The US Dollar should continue to rise against most major currencies.

And, finally, diversified investment portfolios should continue to provide investors steady, upper quartile type returns. It's one thing to like an asset class; it's quite another to accurately estimate what its 12-month return will be. There's far too much central bank intervention in financial markets these days, not to mention geopolitical turmoil for anyone to make a highly accurate forecast. Winners rarely repeat and laggards often rebound. So, with that said, on behalf of all of us at Nottingham, I'd like to wish you a safe, peaceful and joyous holiday season and best wishes for a prosperous new year.

Lawrence Whistler, CFA
President/Chief Investment Officer
December 2014