Another Tough Quarter For Global Diversification

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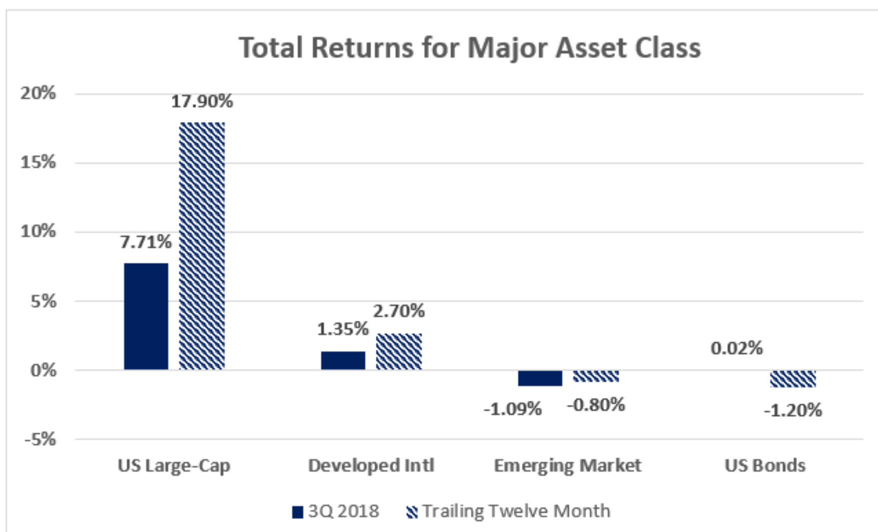
Emotionally, US investors are now getting fed up with diversification, an idea that in our view has worked well over time. We believe they are doing so at, or close to, the wrong time.

DEFENDING DIVERSIFICATION WITH DATA

Sometimes I feel like I have the worst luck. I was reminded of this fact the other day when I found myself in the slowest lane at the toll-booth. Being impatient and in a hurry, I took matters into my own hand and switched lanes…and to my dismay watched the cars in my previous lane begin moving while the progress of the cars in my new lane ground to halt. Additional lane changes only made my situation worse and I quickly concluded that it would have been better if I simply stayed where I started.

My traffic story has relevance to investing, particularly after living through the lopsided investment environment of the last few years. Like me, investors get impatient when they are not currently moving at the same pace as others, and, like me they want to move to where the pace has been the fastest. Unfortunately, we believe that investors who chase performance will encounter similar frustrations and lack of results like I did at the toll booth.

US OUTPERFORMANCE IS ENTICING SOME TO UN-DIVERSIFY



Source: Morningstar Direct, RiverFront. Past performance is no guarantee of future results. Shown for illustrative purposes only, not indicative of RiverFront performance.

As quarterly statements arrive in coming weeks, investors in globally diversified portfolios may be disappointed to find that their accounts only returned a fraction of the S&P 500's return. This is because in the third quarter and over the past twelve months the S&P 500 significantly outperformed most other asset classes (chart above), continuing a theme that has persisted since the Financial Crisis. We anticipate that the disappointing performance from diversified portfolios will once again raise questions about whether diversification still makes sense and recognize that the allure to un-diversify can be overwhelming when it is not working, and an investor's home base is performing well.

CHASING WINNERS’ IS A QUESTIONABLE STRATEGY

“Chasing Winners”, which is the strategy of only buying the best-performing asset class of the prior period, can become a popular replacement for diversification after a long period of underperformance.

However, buying yesterday’s winners is far from a sure-fire recipe for success because winners regularly shift around, which can be seen in the table below. Yesterday’s winner can often become tomorrow’s loser as was the case with treasury bonds, which were the top-performers in 2008 and the worst performers in 2009. Emerging market equities appear to be setting up for a similar “first to worst” performance in 2017 and 2018.

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	10 Year Average	Q3 2018
Treasury Bonds 13.74%	Emerging Market Equities 78.51%	SMID Cap 26.55%	Treasury Bonds 9.81%	Emerging Market Equities 18.22%	SMID Cap 35.87%	Large Cap 13.69%	Large Cap 1.38%	SMID Cap 22.49%	Emerging Market Equities 37.28%	SMID Cap 10.10%	Large Cap 7.71%
Fixed Income Inv. Grade 5.24%	High-Yield 57.51%	Emerging Market Equities 18.88%	Fixed Income Inv. Grade 7.84%	SMID Cap 17.40%	Large Cap 32.39%	SMID Cap 8.54%	Treasury Bonds 0.84%	High-Yield 17.49%	Developed Int'l Equities 25.03%	Large Cap 8.50%	SMID Cap 4.13%
Cash 1.77%	SMID Cap 33.48%	High-Yield 15.19%	High-Yield 4.38%	Developed Int'l Equities 17.32%	Developed Int'l Equities 22.78%	Fixed Income Inv. Grade 5.97%	Fixed Income Inv. Grade 0.55%	Large Cap 11.96%	Large Cap 21.83%	High-Yield 7.89%	High-Yield 2.44%
High-Yield -26.39%	Developed Int'l Equities 31.78%	Large Cap 15.06%	Large Cap 2.11%	Large Cap 16.00%	High-Yield 7.42%	Treasury Bonds 5.05%	Cash 0.03%	Emerging Market Equities 11.19%	SMID Cap 15.33%	Fixed Income Inv. Grade 4.01%	Developed Int'l Equities 1.35%
SMID Cap -34.67%	Large Cap 26.46%	Developed Int'l Equities 7.75%	Cash 0.07%	High-Yield 15.59%	Cash 0.05%	High-Yield 2.50%	Developed Int'l Equities -0.81%	Fixed Income Inv. Grade 2.65%	High-Yield 7.48%	Treasury Bonds 3.31%	Cash 0.48%
Large Cap -37.00%	Fixed Income Inv. Grade 5.93%	Fixed Income Inv. Grade 6.54%	SMID Cap -0.92%	Fixed Income Inv. Grade 4.21%	Fixed Income Inv. Grade -2.02%	Cash 0.02%	SMID Cap -2.11%	Treasury Bonds 1.04%	Fixed Income Inv. Grade 3.54%	Developed Int'l Equities 1.94%	Fixed Income Inv. Grade .02%
Developed Int'l Equities -43.38%	Cash 0.15%	Treasury Bonds 5.87%	Developed Int'l Equities -12.14%	Treasury Bonds 1.99%	Emerging Market Equities -2.60%	Emerging Market Equities -2.19%	High-Yield -4.64%	Developed Int'l Equities 1.00%	Treasury Bonds 2.31%	Emerging Market Equities 1.68%	Treasury Bonds -.59%
Emerging Market Equities -53.33%	Treasury Bonds -3.57%	Cash 0.13%	Emerging Market Equities -18.42%	Cash 0.08%	Treasury Bonds -2.75%	Developed Int'l Equities -4.90%	Emerging Market Equities -14.92%	Cash 0.26%	Cash 0.82%	Cash 0.34%	Emerging Market Equities -1.09%

Source: Morningstar Direct. Past performance is no guarantee of future results. Diversification does not guarantee a profit or eliminate the risk of loss. Please see disclosures for important index definitions and disclosures. Index returns are provided for informational purposes and are not indicative of RiverFront portfolio performance. Q3 2018 data through September 30, 2018.

IN OUR VIEW, DIVERSIFICATION IS A FORM OF HUMILITY

The future is uncertain, which is why we diversify. But one should recognize that the moment a second position is added to a portfolio is the moment they will always own an underperformer. Diversification is certainly not an assurance of higher returns or a protection from losses, and it is not a panacea. In our view, it is a belief that spreading your investments across different countries and asset classes is a helpful approach to reducing risk and smoothing returns.

CASE FOR DIVERSIFICATION REMAINS STRONG

Since 1973 the overall yearly win percentage of international stocks versus those in the US is nearly identical in US dollar terms. We recognize that it often does not feel that way since there were two long-term mega streaks for each side over that time period, including the now decade-long hot streak the US is currently riding. RiverFront’s asset allocation framework, based on the potential of long-term mean reversion, suggests to us that international equities are priced to return significantly more over the next 5-10 years than US equities. We remain committed to diversification and to increasing weightings to those asset classes that have been underperformers, so long as we think they are attractively priced.

IN CONCLUSION

Timing is hard, and momentum can persist longer than investor emotions can tolerate. That said, in our experience, abandoning a previously determined diversified investment plan after it has underperformed a single asset class could be a decision that is later regretted.

Important Disclosure Information

Diversification does not ensure a profit or protect against a loss.

Past results are no guarantee of future results and no representation is made that a client will or is likely to achieve positive returns, avoid losses, or experience returns similar to those shown or experienced in the past.

The comments above refer generally to financial markets and not RiverFront portfolios or any related performance.

Information or data shown or used in this material is for illustrative purposes only and was received from sources believed to be reliable, but accuracy is not guaranteed.

Small, mid, and micro cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

In a rising interest rate environment, the value of fixed-income securities generally declines.

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Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

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Asset Class Definitions:

*S&P 1000 Index TR USD (**SMID Cap**) is a combination of the S&P Mid Cap 400 Index TR USD & S&P Small Cap 600 Index TR USD.*

*Standard & Poor's (S&P) 500 Index TR USD (**Large Cap**) measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.*

*MSCI Emerging Markets Index NR USD (**Emerging Market Equities**) is an equity index that captures large and mid cap representation across 23 emerging markets (EM) countries.*

*Bloomberg Barclays Capital US Treasury Index TR USD (**Treasury Bonds**) measures the performance of the US Treasury bond market.*

*MSCI EAFE Index NR USD (**Developed International Equities**) is an equity index that captures large and mid cap representation across developed markets countries around the world, excluding the US and Canada.*