



“Here is part of the tradeoff with diversification. You must be diversified enough to survive bad times or bad luck so that skill and good process can have the chance to pay off over the long term.” - Joel Greenblatt¹

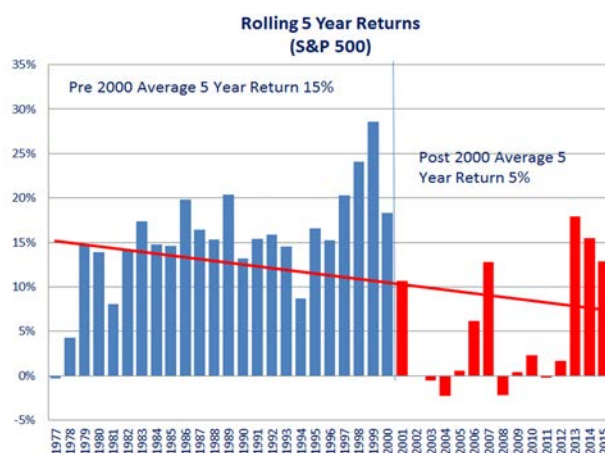
Over the course of what has been a 20-year investment career, I’ve written dozens of articles and given at least as many presentations in person. Some of these let’s call run of the mill market updates, while others were more topical, much like the content you find in this Market Insights series. Never during my entire career would I ever have imagined that I would deliver a presentation or author an article titled *Solving the Diversification Problem*. In fact, it’s such an awkward topic that I choke on it as it rolls off my tongue. After all, most of us have been taught and believe that diversification is a good thing. Don’t put all your eggs in one basket. Sound advice. But it hasn’t worked, at least not recently. In fact, diversification has been a major headwind for investors, especially those like us who believe in owning multi-asset class portfolios with the goal being to outperform a benchmark. On top of that, for the balance of the past 17 years, investors have struggled to meet their investment goals for two other reasons; high valuations and historically low interest rates. Our intention is to speak to these issues directly and identify some possible solutions to the major obstacles investors have, and continue to face when attempting to meet their investment goals.

Return Compression

A moment ago, I referenced the failure of investors to meet their investment objectives for the balance of the past 17 years. Given the length of time, and the fact that the failure is in opportunity cost and not in declining investment account balances, some may not even realize where the failure

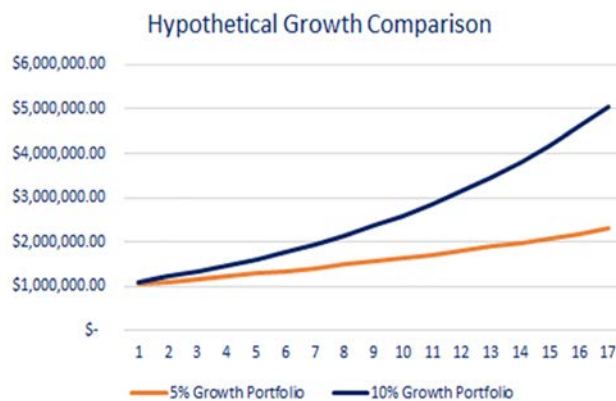
Cost of Compressed Returns

Chart 1



Data Source: Standard & Poors, MPI Stylus

Chart 2



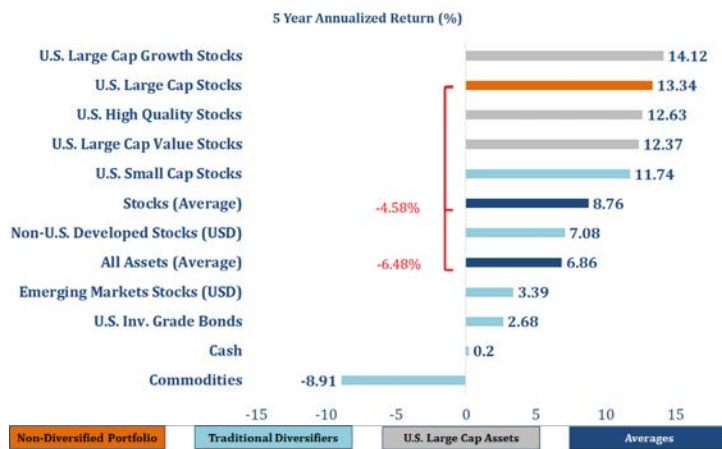
¹ Joel Greenblatt (born December 13, 1957) is an American academic, hedge fund manager, investor, and writer. He is a value investor, and adjunct professor at the Columbia University Graduate School of Business. He is the former chairman of the board of Alliant Techsystems and founder of the New York Securities Auction Corporation. He is also a director at Pzena Investment Management, a high-end value firm. Source: Wikipedia

occurred. Most savers over this period will be able to identify with the fact that something has just gone wrong. That is, they aren't where they thought they would be.

Think for a moment about what you expect from your stock portfolio. While we can all hope and wish for 20% returns, realistically most will answer about 10%, which is approximately the long-term historical average return. While certainly a reasonable guess and expectation, the fact is

The Diversification "Problem"

Chart 3



Data Source: Russell, S&P, MSCI, Bloomberg, iCM Capital Markets Research

While diversification is generally sound advice, over the past 5-years it has failed investors, as each of the common diversifiers have trailed the US market. This has cost equity investors 4.58% from their portfolio returns and investors who diversified into fixed income 6.48% from their returns.

that we haven't been living in that reality for quite some time. While the 5-year rolling return prior to 2000 was solidly above what most expect from their stock portfolios, since then we have been living in a mediocre-at-best, mid-single digit return environment of approximately 5% for stocks. You've worked hard, you've saved diligently and yet maybe you've found yourself wondering what went wrong. Have you saved enough? Have you worked long enough? Have you made poor investment choices? When you look at your account does it simply seem like it isn't where you thought it would be at this point? If so, nearly two decades of diminished returns due to high valuations are to blame. The fact is, in a very stealthy way, the last 17 years have cost investors millions of dollars through probably no fault of their own. The environment was just bad! Take for example, Chart 2 which compares the compounding effect of a 10% return environment versus a 5%

return environment on a \$1mm portfolio. Over 17 years both grow in value, with the 5% growth portfolio more than doubling to nearly \$2.3mm. However, over the same period, the 10% growth portfolio increases to over \$5mm. To put this in perspective, one can generally invest and safely distribute about 4% per year from their investment portfolio in retirement. This is the difference between \$80k per year in retirement income versus \$200k per year. If you still need convincing, ask someone whose financial plan projected them to have \$200k in income, but only gave them \$80k. The effects are slow to develop and plans can be adjusted over the years, but the impact is devastating nonetheless.

In my introductory remarks, I mentioned there were two culprits that can share blame for this lousy environment, high valuations and low interest rates. When we say high valuations, the thought that most commonly comes to mind is a market crash. Admittedly, that is a possible consequence of elevated valuations. But even from today's lofty valuation levels, the probability of a spectacular crash, say 20% or more, is only about 33%, statistically speaking. As I say that, I hear most breathing a sigh of relief. However, bad downturns are five times more likely to occur from elevated valuations like we see today, as opposed to more normal environments, so we do need to be mindful of that possibility. The truly sinister effect of elevated valuations has

nothing to do with crashes. It's that they act like a steady wind in your face, slowly sapping the energy from your portfolio until you look up 17 years later and you've lost 5% per year from your expected normal returns without knowing why.

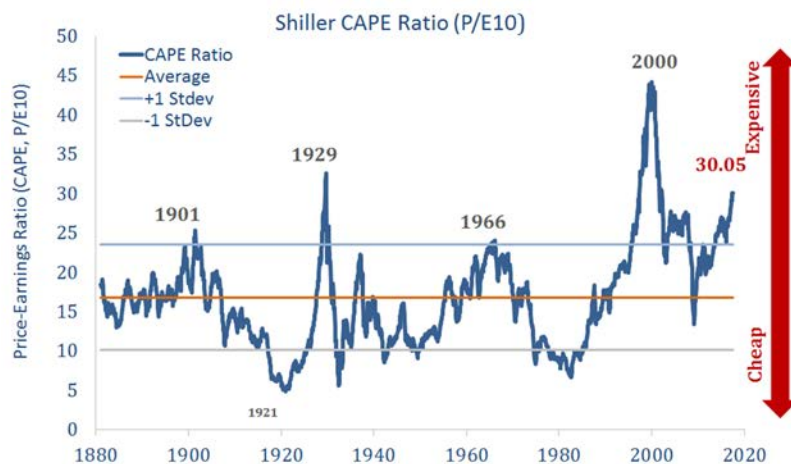
The Diversification "Problem"

The second problem facing investors, while shorter in length, has been equally frustrating. For the past 5 years, diversification has failed. Despite this statement and what I'm about to show you, not putting all your eggs in one basket remains sound advice. Chart 3 details the performance of many of the major asset classes over the past 5 years. The orange bar is the US stock market, as represented by the S&P 500 index. This is your traditional non-diversified portfolio. The light blue bars are your diversifiers. Portfolio construction normally works in the following manner. Start with the US large cap stocks, sprinkle in some small cap stocks, international and emerging markets equities, perhaps some commodities to hedge inflation, add some bonds to dilute the risk to a palatable level and voila, you have a portfolio that is diversified across market cap, geography, risk level, and inflation effect. Study the table carefully. The first and most obvious takeaway is that all of the light blue bars are below the orange bar, meaning all the diversifiers trailed the US market. If you diversified over the past 5 years, it cost you performance. What was that cost? For an all equity investor who diversified only among equity investments, that cost was 4.58% per year. If you included bonds and commodities, the cost was 6.48% per year. Depending on your taste for risk and the degree to which you diversified, diversification caused you to trail the performance of the US stock market by 4 ½ to 6 ½ % per year for the past 5 years.

So, what do we do? A simple fix is not to diversify, which we've already stated isn't sound advice. Let me present you with two scary reasons why. For this, I give you Charts 4 and 5. As we discussed in our introduction, stock prices are expensive. In fact, from Chart 4 above, we can see that current levels are more expensive than all markets over the past 140 years except for the Great Depression in 1929 and the Internet Bubble in 2000. This includes the credit crisis

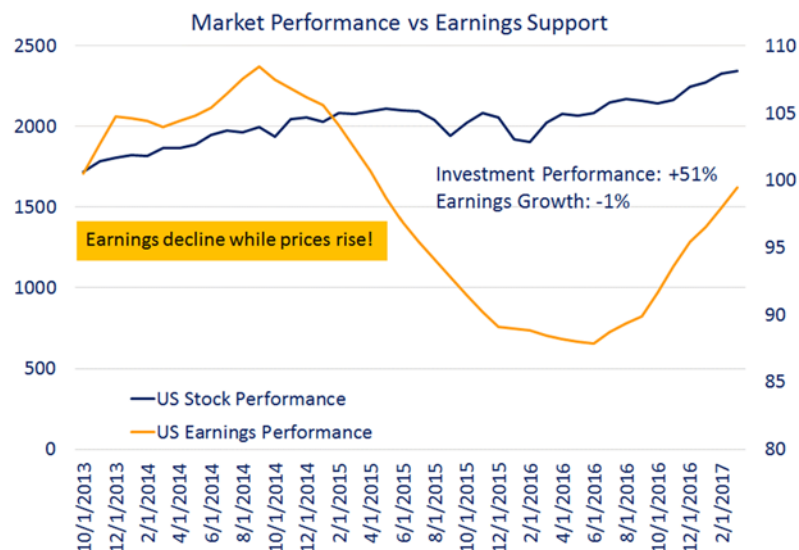
Remain Diversified!

Chart 4



Data Source: Shiller Data Library, iCM Capital Markets Research

Chart 5



Data Source: Standard & Poors, iCM Capital Markets Research

Lofty valuations and poor earnings support for US stocks provide a better case now more than ever for staying diversified.

in 2008. To make matters worse, I present Chart 5. Over the past 4 years, US equities have appreciated by 51% (at last some headway!). At the same time, earnings, which are the life blood of stock price gains, have declined by 1%. The 51% gain has been built on a weak foundation, zero earnings justification or support...all speculation. Abandoning diversification for any reason is a poor decision, but abandoning diversification to concentrate in an asset class with these characteristics will likely be a costly decision.

Search for Gems on the Road Less Traveled

So where does this leave us? Likely, staring at a return environment for the foreseeable future that looks like the past 17 years, at best. While I will spare you the details of the calculation, it requires some creative math to get anywhere close to the long-term average return of 10% for any sustainable length of time for US equities. For those that are banking on tax reform or any other form of fiscal policy or financial engineering, I would encourage you to read both our 2nd and 3rd quarter market insights. We could expect some help around the edges from tax reform, but only at the margin. Sadly, the problem is not likely to be solved without pain. This has left some investors feeling trapped because they've pigeon holed themselves with large allocations to an expensive US asset class due to home country bias. But, the death of diversification has been greatly exaggerated. Non-dollar denominated assets like emerging markets stocks and bonds, international developed markets stocks, and real assets all offer much better return prospects than US markets for several reasons, not the least of which being valuations are a fraction of what they are in domestic markets. In addition, all three should benefit from currency tailwinds, while emerging and developed international equities should receive a boost from earnings, as both variables have shifted to unsustainably depressed levels. Rebounds in both are likely over any sufficiently long-time horizon and should be additive to returns. As discussed at length, all are key components to our strategies. From here the pickins' get slim, as they say, in conventional asset class space. While I will save opining on the future of investment management and what my beliefs are on how portfolio construction has changed for a later date, suffice it to say, our current unique times are requiring thoughtful and unique solutions. I suspect this may involve investors learning to become more comfortable with unconstrained portfolios, but also arriving at their desired risk levels much differently than they do today. Again, a topic for a later day.

For now, we find ourselves looking for new opportunities, by searching the road less traveled. This has lead us to uncover great potential in closed end fund (CEF) space. For those who aren't familiar, closed end funds, much like mutual funds and exchanged traded funds (ETFs) are diversified baskets of hundreds of underlying securities. While CEFs and ETFs trade intraday like stocks, mutual funds trade once at the end of each day. What separates closed end funds from ETFs is pricing. When you buy an ETF or a mutual fund, \$1 worth of assets gets you \$1 worth of portfolio. With closed end funds, you may get more or less than \$1 worth of portfolio for the same dollar of assets. This is called trading at a premium or discount to net asset value (NAV). One can, at times, acquire \$1 worth of portfolio by only paying 90 cents (or less under stressed market environments). Therein lies the opportunity. Through a flaw in the pricing structure of the product, we believe that there are opportunities in closed end fund space to manufacture an additional layer of return for investors. Additionally, a nice side effect of closed end fund investing is a portfolio with elevated yield characteristics, currently in the range of 4-5%. Pitfalls, of course, exist. One must be astute enough to evaluate these discounts, account for and diversify the risks, not only of the closed end fund discounts, but also with regard to the asset classes they represent. That said, each of these risks tend to fit neatly into our existing framework of asset class valuation and risk management. This has allowed us to introduce another potential opportunity into a universe, where as I've said previously, the pickins' are slim.

Since the turn of the century, despite gains in their portfolios, investors have had a tough row to hoe. High valuations in and after the internet bubble have ushered in an era of low returns versus what many expect from their stock portfolios. Over the past 17 years, this has cost many, half of the gains that would have accrued, had the historical average return of 10%

materialized. Unfortunately, it didn't. The average was 5%, and it was costly. Additionally, diversification, the long-term best friend of the investment world has laid a proverbial egg over the past 5 years. Diversifying across equity assets has caused investors to underperform US markets by 4 ½ % per year, while including bonds and real assets brought that total cost of underperformance to 6 ½ %. Alas, take heart that better days should lie ahead for many of these diversifiers. Emerging markets equities and debt, international stocks, commodities, and certain closed end funds appear to be possible solutions to an overpriced US Equity market. While this circular journey has left us back where we began, it serves to reinforce our conviction in our current portfolio positioning, and our new journey into closed end fund space. As always, we encourage investors to remain focused on the long-term and avoid being emotional if adversity should arise. Thank you for your trust and confidence.

4th quarter 2017 Market Insights is intended solely to report on various investment views held by Integrated Capital Management, an institutional research and asset management firm, is distributed for informational and educational purposes only and is not intended to constitute legal, tax, accounting or investment advice. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Integrated Capital Management does not have any obligation to provide revised opinions in the event of changed circumstances. We believe the information provided here is reliable but should not be assumed to be accurate or complete. References to specific securities, asset classes and financial markets are for illustrative purposes only and do not constitute a solicitation, offer or recommendation to purchase or sell a security. **Past performance is no guarantee of future results.** All investment strategies and investments involve risk of loss and nothing within this report should be construed as a guarantee of any specific outcome or profit. Investors should make their own investment decisions based on their specific investment objectives and financial circumstances and are encouraged to seek professional advice before making any decisions. Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Indexes are unmanaged and investors are not able to invest directly into any index. The S&P 500 Index is a market index generally considered representative of the stock market as a whole. The index focuses on the large-cap segment of the U.S. equities market.



Integrated|Capital|Management

410 Spruce Street, 4th Floor, Scranton, PA 18503
Phone: (570)344-0100, Email: info@icm-invest.com
www.icm-invest.com