

## ABR Dynamic Funds' Portfolio Construction Series: Part 18

*Superficial diversification may hide concentrated equity bets*

In 2009, Warren Buffett famously made “an all-in wager on the economic future of the United States.”<sup>i</sup> In 2019, many investors don't realize they are making the same wager, **but after the recovery and after 10 years of abnormally high equity returns.**

### Behaviors vs. Wrappers

The components of a portfolio are behaviors, not wrappers. An investment's behavior is its results, when and how much it gained and lost. Its wrapper is most everything else, such as name, Morningstar category, vehicle/structure, etc. **The wrapper has rarely mattered.** For example, if two investments consistently gained and lost at the same time, then it doesn't matter what they are called. One can be a “long/short equity alternative hedge fund,” while the other is an “S&P 500 Index tracking ETF.” If they behaved the same way, then they had the same effect on a portfolio. None of this is just semantics. This understanding carried huge consequences for investor outcomes.

This installment will unwrap a conventional 60/40 portfolio and a more sophisticated portfolio to show that they may have effectively just been equity behavior. The next installment will introduce a simple principle for constructing better portfolios and begin constructing them.

### 60/40 Unwrapped

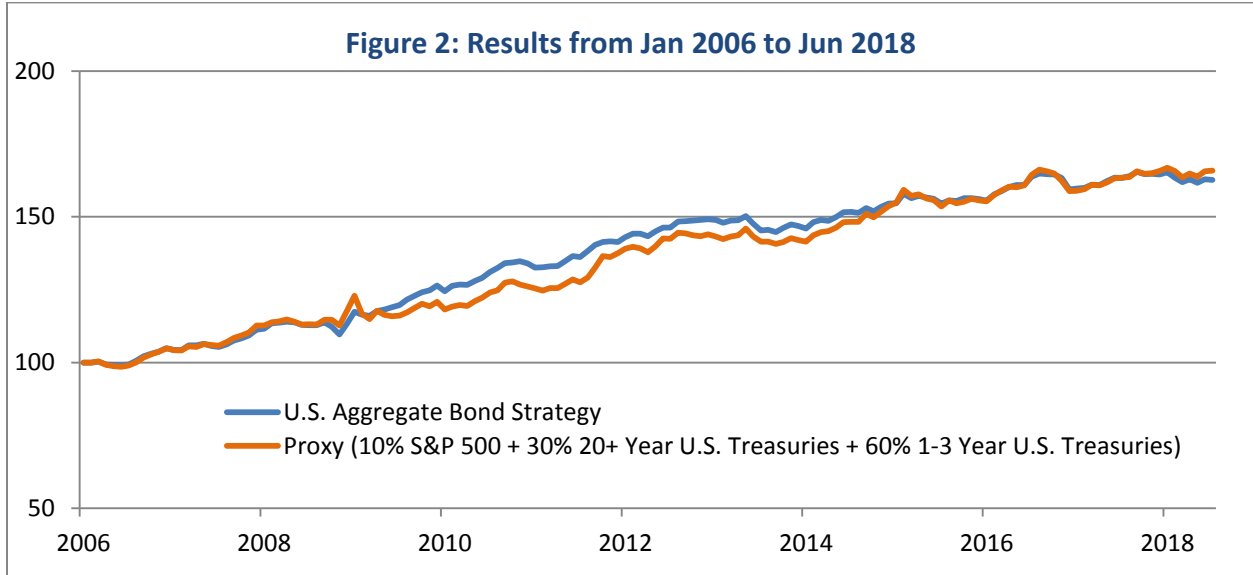
Many investors think 60/40 is well diversified because it is composed of 60% equity wrappers and 40% bond wrappers. However, a focus on behaviors, instead of wrappers, reveals a problem. There is equity behavior hiding in the bond wrappers. **In fact, High Yield (or COREPLUS) bonds have behaved much more like stocks than like government debt.** Despite this rather well-publicized fact, many investors, who think they are in some variant of 60/40, take several steps which collectively put them much closer to 80% equity behavior.

To smooth bond returns, many investors look to Aggregate Bond strategies. These strategies have typically just added equity behavior to the interest rate behavior more commonly expected from bond allocations. To illustrate, we have created a proxy for an Aggregate Bond strategy using only the S&P 500 for equity behavior and long-dated U.S. treasuries for interest rate behavior (as well as short-dated treasuries for nearly cash-like behavior). The behaviors of the proxy and the Aggregate Bond strategy were quite similar.

- **Aggregate Bond Strategy vs. Proxy**

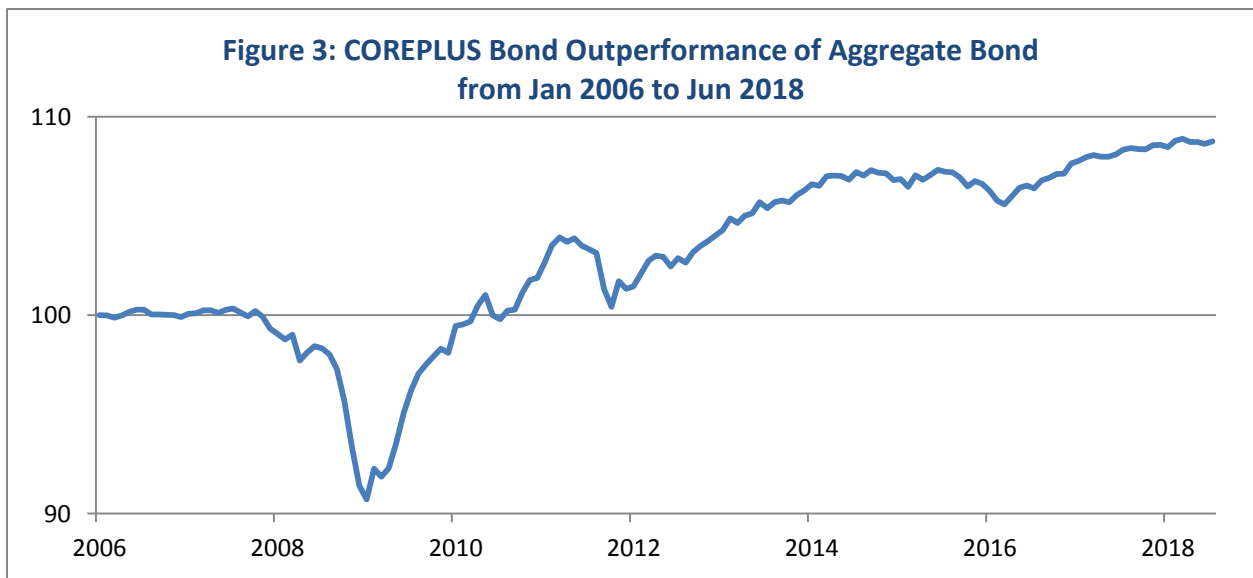
- Proxy Allocations:

- 10% equity behavior (SPY – S&P 500 ETF)
    - 30% interest rate behavior (TLT – 20+ Year U.S. treasury ETF)
    - 60% short-dated U.S. treasuries (SHY – 1-3 Year U.S. treasury ETF)



Source: ABR white paper (data from Bloomberg)

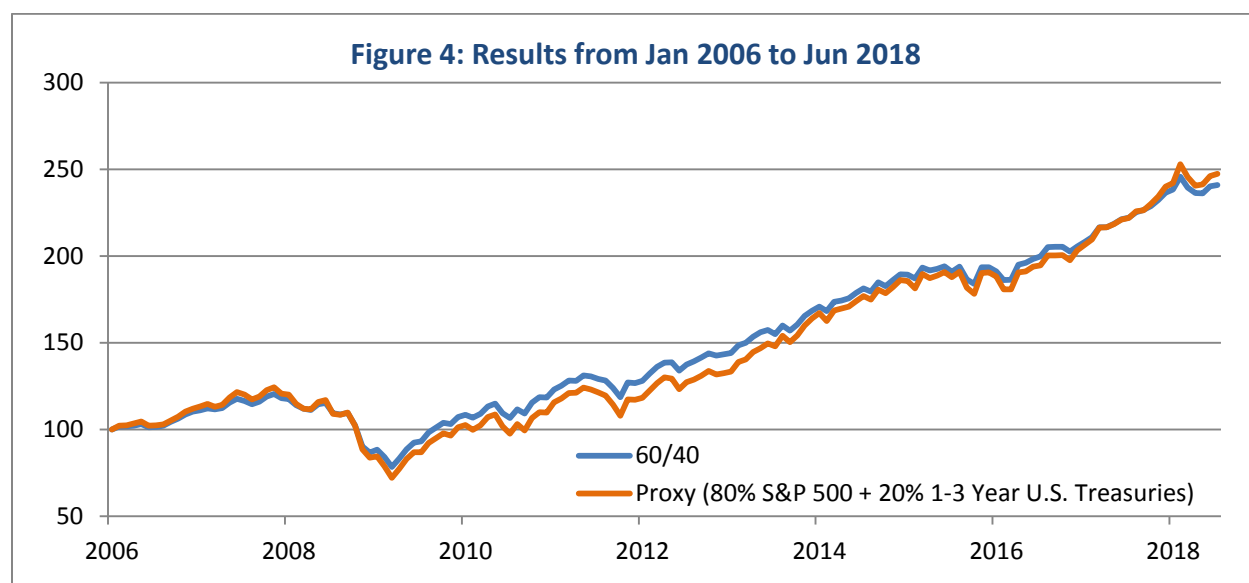
To increase bond returns, many investors look to COREPLUS or High Yield bond strategies. **“COREPLUS” might as well be called “core plus equity” because these strategies typically achieved their outperformance by just adding even more equity behavior.** To illustrate, the following graph shows the outperformance that a typical COREPLUS bond strategy has achieved over an aggregate bond strategy. The graph will look familiar to most readers. It exposes the extra equity behavior in many COREPLUS bond strategies, especially around crises, such as the Financial Crisis and the Greek Debt Crisis.



Source: ABR white paper (data from Bloomberg)

The net result of seeking smoother and increased performance in bond allocations has been undue concentration in equity behavior. The following illustration uses a COREPLUS bond strategy for the 40 in 60/40. The proxy shows that the portfolio was effectively little more than the S&P 500.

- **60/40 vs. Proxy**
  - Proxy Allocations:
    - 80% equity behavior (SPY – S&P 500 ETF)
    - 20% short-dated U.S. treasuries (SHY – 1-3 Year U.S. treasury ETF)



Source: ABR white paper (data from Bloomberg)

Smoothing and increasing returns are appealing goals. However, focusing on these goals within each component of a portfolio only served to increase the portfolio's concentration in equity behavior. **Remember, the goal is not to smooth and increase the returns of the individual components of a portfolio but to smooth and increase the returns of the overall portfolio.** These are two separate goals, and, perhaps surprisingly, optimizing individual components in this way can often be counterproductive to the overall portfolio.

We cannot overstate how important this point is, and how many investors overlook it. **If a component is selected for its ability to diversify (i.e. be different from) equity behavior, then that component often should not itself be diversified and optimized as though it were an entire portfolio instead of a component of a portfolio. The end result of this process is frequently the addition of equity behavior to components that were selected for the very purpose of being different from equity behavior.**

In fact, the end result was 80% S&P 500 exposure, not far from "an all-in wager" on stocks.

## Global Family Office Portfolio Unwrapped

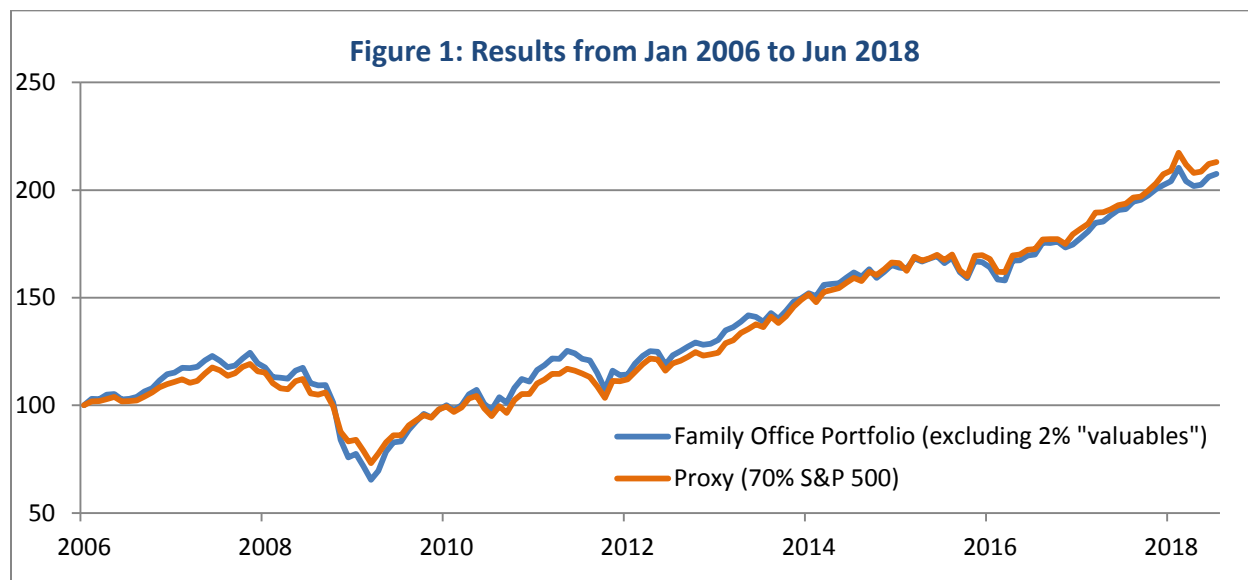
More complicated portfolios were often no better. According to the Campden Global Family Office Report, the average portfolio has the following allocations to each of 8 categories, represented by the choices specified in the final column.

Allocation	Global Family Office Investment Category	Represented by
37%	Stocks and Bonds	22% S&P 500 + 15% COREPLUS Bonds
29%	Private Equity, Venture Capital, Real Estate	10% P.E. + 10% Tech + 10% R.E.
8%	Cash or Equivalent	8% Short-dated U.S. treasuries
8%	Hedge Funds	8% H.F. Index
7%	Private Equity Funds	7% P.E. Index
4%	Agriculture and Commodities	4% Commodity Index
4%	Exchange Traded Funds, Real Estate Investment Trusts	2% S&P 500 + 2% R.E.
2%	Valuables (Art, etc)	None

Numbers do not sum to 100% due to rounding

This portfolio appears well-diversified, at least by wrapper. However, a look at behaviors reveals that it was little different from the 60/40 portfolio above. We have covered the reasons for the lack of true behavioral diversification in this portfolio in several of the fooled by the wrapper installments in this series on portfolio construction. The following simple proxy illustrates the net result:

- **Average Global Family Office Portfolio vs. Proxy**
  - Proxy Allocations:
    - 70% equity behavior (SPY – S&P 500 ETF)
    - 30% idle capital



Source: ABR white paper (data from Bloomberg)

As the proxy indicates, many of these allocations were mostly just forms of equity behavior. Furthermore, where these allocations differed from each other, they sometimes offset each other. For example, hedge funds often just provided diluted equity behavior while private equity often just provided leveraged equity behavior. After dilution and leverage, investors may have been right back where they started, but with a higher price tag.

This average global family office portfolio resulted in another surprisingly concentrated equity bet, especially given the obvious effort at diversification.

We are not suggesting anyone has all the answers. However, to complete the story from the beginning of this installment, Warren Buffett has recently said he can't find anything big to buy. "Prices are...far from spectacular. Indeed, price [seems] almost irrelevant to an army of optimistic purchasers."<sup>ii</sup> Meanwhile, many investors are still (often unknowingly) making an "all-in wager" on the stock market.

*Next Week's Preview: Next week's installment introduces a simple principle for constructing better portfolios.*

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<sup>i</sup> <https://www.telegraph.co.uk/finance/newsbysector/transport/6494951/Warren-Buffett-makes-44bn-bet-on-US-recovery-with-railroad-deal.html>

<sup>ii</sup> <https://www.wsj.com/articles/warren-buffett-cant-find-anything-big-to-buy-11550745001>