Portfolio Construction

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Exploring Capital Efficiency

Investment Choices That Help Unlock the Full Benefits of Diversification

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"Diversification is the only free lunch in investing," said Harry Markowitz, father of modern portfolio theory. But many investors who tried to follow this advice during the last 15 years found their diversification lunch to be rather costly. This was partly because of an exceptional market environment—a 15-year bull market in U.S. large-cap equities. It was also because Markowitz was implicitly assuming that investors can and will use leverage.

But investors don't need to borrow money themselves to make the portfolio math work for them. They can invest in levered strategies such as private equity or hedge funds, or tilt towards higher-risk segments of a market, like small-cap stocks or high duration bonds, which deliver more investment "bang for the buck" and allow capital savings to be deployed elsewhere. In this article we assess the benefits, costs and risks of these different sources of capital efficiency, to determine which of them offer the best route to improved portfolio diversification *and* higher long-term returns. We find that capital efficient investments can deliver substantial benefits at the portfolio level, especially for leverage constrained investors.

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