Alternative Thinking

It Was the Worst of Times: Diversification During a Century of Drawdowns

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Big equity drawdowns happen time and again and tend to drag down typical investor portfolios with them. Unfortunately, attempting to tactically avoid the next equity sell-off is likely to disappoint investors. This article uses nearly 100 years of data to evaluate the effectiveness of diversifying investments during the worst of times for most portfolios. We analyze the potential benefits and costs of shifting away from equities, including into investments that are diversifying (i.e., lowly correlated) and investments that are defensive (i.e., expected to outperform in bad times). With regard to the latter, we observe an intuitive trade-off: investments with better hedging characteristics tend to do worse on average. Investors should evaluate this trade-off in deciding how—and how much—to diversify their exposure to equity drawdowns.

eliminate the risk of experiencing investment losses.

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