



# Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

JUNE 2009

## Reflections on the Financial Crisis: When Diversification Failed

**Nicholas P. Sargen, PhD**  
Chief Investment Officer

**Thomas L. Finn, CFA**  
Vice President & Senior Portfolio Manager

**Charles A. Ulbricht, CFA**  
Vice President & Senior Portfolio Manager

- **No Place to Hide**
- **What Made the Crisis So Severe?**
- **What to Do Now?**
- **Lesson for Investors**

---

*Past performance is not indicative of future results. This publication contains the current opinions. Fort Washington Investment Advisors, Inc. Such opinions are subject to change without notice. This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Fort Washington, or its affiliates, may from time to time provide advice with respect to, acquire, hold, or sell a position on the securities mentioned herein. Information and statistics contained herein has been obtained from sources believed to be reliable but are not guaranteed to be accurate or complete. No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission of Fort Washington Investment Advisors, Inc.*

*Fort Washington, or its affiliates, may from time to time, provide advice with respect to, acquire, hold, or sell a position on the securities mentioned herein.*

©2009 Fort Washington Investment Advisors, Inc.



For professional investors and financial planners alike, the past year and a half has been one of the most challenging ever. Cumulative losses on stocks, bonds, real estate and other investment vehicles are estimated to be in the vicinity of \$50 trillion globally, with roughly one third of that coming from the United States. Most portfolio managers were unable to avoid large losses, including some renowned value investors. Even sophisticated university endowments that contain large allocations to alternative investment vehicles reportedly suffered losses in the range of 25%-30%.

Amid all this, investment professionals have had to confront why returns were so poor. The standard explanation is there was no place to hide other than cash or U.S. treasuries. In this article we investigate whether this explanation is valid; and if so, why diversification failed to protect portfolios. We then consider what investment strategies are appropriate going forward, as well as the lessons to be gleaned from this experience.

Following are our principal conclusions:

- (i) The assertions are valid -- except for cash, treasuries and gold, all asset classes experienced steep sell-offs. Furthermore, international diversification detracted from overall investment returns, and the style of equity management made little difference.
- (ii) While diversification is often ineffective in down markets, the systemic threat to the global financial system made the current crisis especially painful. As markets became illiquid and money managers faced redemptions, they sold what they could and built cash cushions for added protection.
- (iii) Now that financial markets have rallied significantly, investors confront a new dilemma – when and how to deploy their excess cash. We have done so gradually, moving into corporate bonds first while contemplating adding to equities on market pullbacks. Longer-term, we believe equity returns could be below average, as U.S. economic growth is likely to be below the 1982-2007 trend rate, while inflation could be higher. Consequently, we are considering inflation-protection strategies once recovery takes hold.
- (iv) A key lesson is that traditional rules governing risk control need to be buttressed, especially when there is systemic risk. Added steps beyond setting prescribed limits on individual names are necessary including limiting concentrations of risk by sector (e.g. financials) and type of instrument (RMBS, CMBS etc.), and assessing counterparty risks thoroughly. Finally, we are exploring ways to add new sources of diversification to counter rising correlations among markets and sectors.

## No Place to Hide

*Question: Are the claims of money managers that there were few places to hide valid, or are they merely an excuse?*

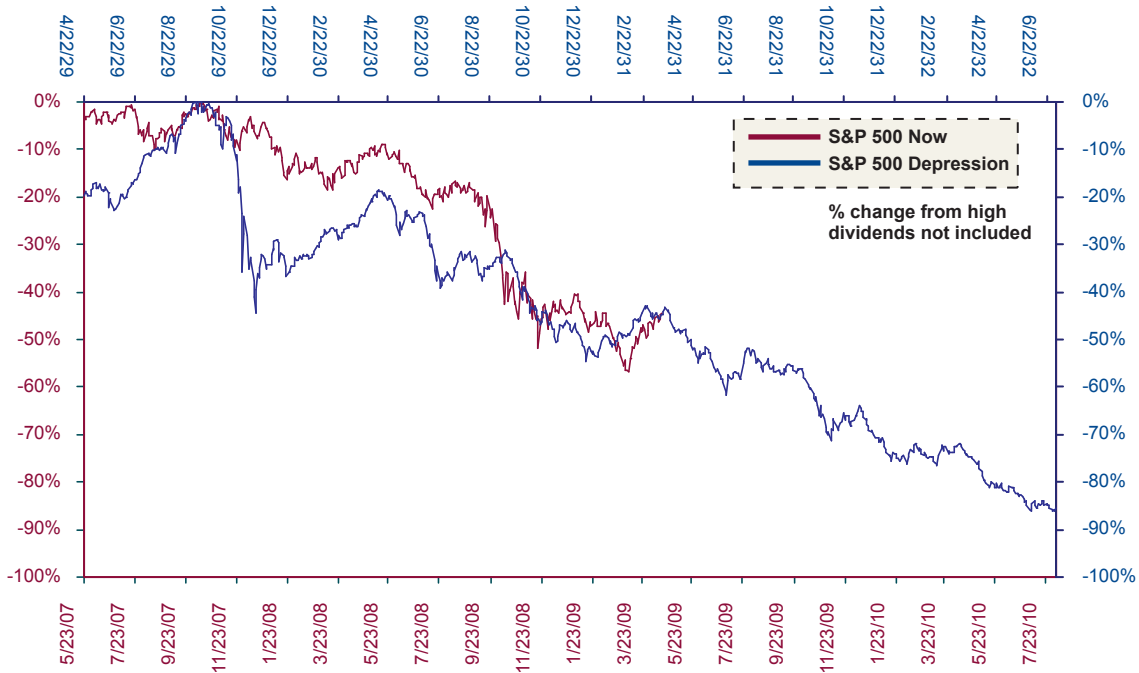
This issue is relevant, because there usually are opportunities for money managers to avoid losses in bear markets. During the bursting of the tech bubble, for example, equity growth managers sustained large losses from 2000 to 2002, as the Nasdaq plummeted by nearly 80%. However, the environment then was much more favorable for equity value managers. They posted healthy gains until 2002, when a series of corporate scandals caused the entire market to sell-off. Even then, hedge fund managers were able to generate positive returns, which laid the foundation for rapid growth of alternative investments. Also, investors could reap handsome returns by investing in housing or real estate.

By comparison, the current financial crisis is more severe and pervasive. Measured from the peak in October 2007 to the trough in early March 2009, the U.S. stock market selloff totaled 55%, which rivals that during the Great Depression (see Figure 1).



Figure 1

### The Stock Market Mirrors the Great Depression



Source: TrendMacro

Moreover, no sector has been spared. Through the end of March 2009, financial stocks declined about 74%, while industrials were off 56%. Even defensive sectors such as consumer staples and healthcare suffered losses of 22% and 31%, respectively. As a result, there has been little differentiation in returns by investment style or market capitalization in the current cycle. Every category – value, growth and blend -- registered market declines of approximately 50% (see Figure 2). Moreover, international and emerging markets fared even worse, such that there was no benefit from international diversification.

Figure 2

U.S. Equity Market Total Returns, by Style

Since Market Peak (October 2007 through end March 2009)

Source: JP Morgan Asset Management

	Value	Blend	Growth
Large	-51.8	-47.2	-43.0
Mid	-52.0	-50.2	-48.8
Small	-49.3	-48.8	-48.5

Normally, investors can count on bonds to help cushion the impact of equity market downturns. However, this was not true in 2008 for corporate bonds, which sold off alongside equities: Investment grade bonds posted a decline in total return of 5%, while high-yield bonds lost a record 26%. While the Lehman (now Barclays) Aggregate Index generated a positive return, this mainly reflected a rally in treasuries. Nonetheless, because fixed income managers typically do not have large treasury holdings, returns for the vast majority of bond managers were considerably below their benchmark.

Finally, alternative investments failed to offer any downside protection. Thus, 2008 returns were negative for every category: private equity (-6%), hedge funds (-19%), real estate (-38%), commodities (-36%) and currencies. Consequently, with the exception of cash and treasuries, portfolio construction made little difference to investment returns.

What Made the Crisis So Severe?

This begs the question of why the current crisis has been so much worse than others, and why so few economists, policymakers and investment professionals saw it coming. We believe the principal reason is that most observers were lulled into complacency by 25 years (1982 to 2007) of steady economic growth, low inflation and record wealth creation. While financial markets sold off periodically, they eventually rebounded and the U.S. economy and the financial system proved to be highly resilient to shocks. This was particularly true after 2002, when the global economy experience its strongest growth in the postwar era, financial institutions posted record profits, and U.S. and global equities set all-time highs.

As a result, market participants and policymakers were inclined to downplay problems as the current financial crisis unfolded. When delinquencies on subprime mortgages began to rise in early 2007, for example, the problem was considered to be relatively minor and isolated. Indeed, the original estimate of losses incurred on subprime loans by the Federal Reserve was only \$100 billion. Even when problems spilled over to credit and money markets in the latter part of 2007 and Bears Stearns had to be rescued in early 2008, investors were comforted as the Federal Reserve eased monetary policy and took other actions to limit the damage. For the most part, the problem was believed to be confined to the United States: By mid-year, U.S. and world equity markets were down by about 10%, but bonds were flat and oil and commodity prices soared, as investors believed the global economy was in good shape.



This illusion was shattered in September, when Lehman Brothers was allowed to fail, and several other prominent financial institutions including Fannie Mae, Freddie Mac, and AIG had to be rescued, and the remaining investment banks had to alter their structure to survive. Money markets seized up, as financial institutions worried about counterparty risks, and capital markets virtually ground to a halt. All of this engendered a massive flight to quality, in which hedge funds and mutual funds faced sizable redemptions.

At the lows in early March, the sell-off in world equity markets rivaled that during the Great Depression, and the global economy experienced its steepest contraction in the post war era: The U.S. economy sustained annualized quarterly declines in real GDP of 6%, while Japan and Germany suffered even greater losses as world trade collapsed. At the same time, massive write-downs by financial institutions and concerns about their ability to raise capital raised the prospect of widespread nationalizations. Confidence in the financial system also plummeted as policymakers responded to events haphazardly and politicians looked for scapegoats. Amid all this, investors were left to wonder what the rules of the game were, if there were any rules.

### What to Do Now?

Just when it seemed no relief was in sight, U.S. and world equity markets have posted strong gains that have erased losses in the first two months of this year (See Figure 3). At the same time, corporate bonds – both investment grade and high yield – have rallied, while treasuries have sold off, narrowing the spreads between them noticeably. (See Figure 4) Consequently, investors now face a new dilemma: Should they put money back into the markets and if so, where and when?

Figure 3

#### 2009 Investment Results (as of 5/31/09)

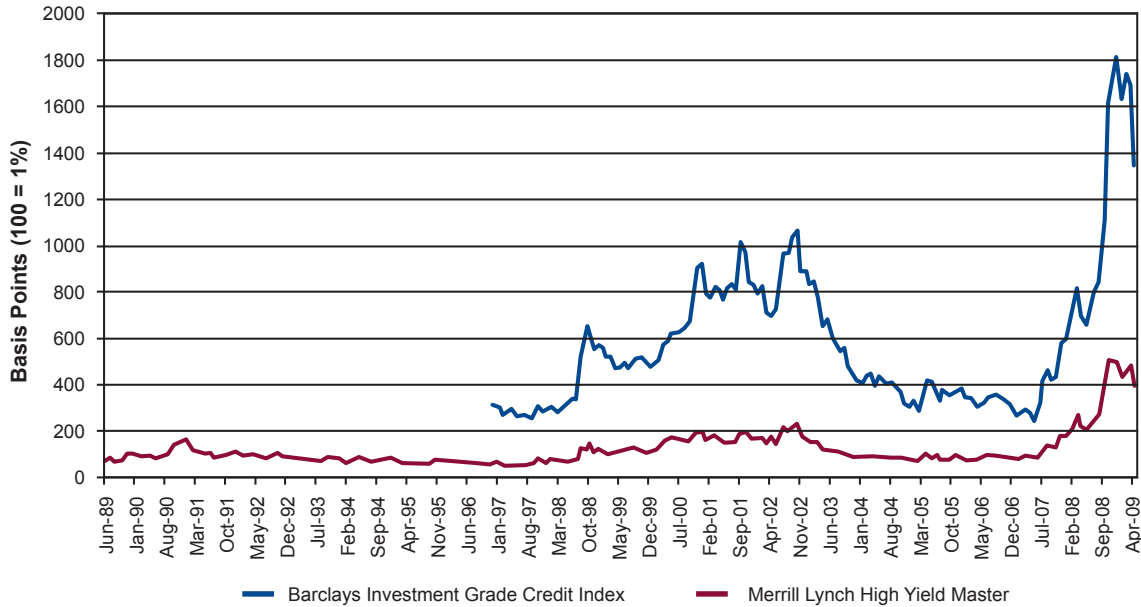
	YTD 5/31/09	Jan-Feb 09	Mar-May 09
<b>Equities</b>			
S&P 500	3.0%	-18.2%	25.8%
EAFE <sup>1</sup> (\$)	9.0%	-19.0%	34.6%
EM <sup>2</sup> (\$)	38.1%	-11.7%	56.3%
<b>Bonds</b>			
Treasuries	-4.1%	-3.4%	-0.7%
Corporate	4.3%	-1.7%	6.2%
High Yield	25.3%	1.8%	23.1%
<b>Commodities</b>			
Oil <sup>3</sup> (WTI)	48.7%	0.4%	48.2%
CRB <sup>4</sup> (all)	10.2%	-7.8%	19.6%
Gold	11.0%	6.8%	3.9%

Source: Bloomberg; Fort Washington

<sup>1</sup>Europe, Australasia, and Far East Index; <sup>2</sup>Emerging Markets; <sup>3</sup>West Texas Intermediate (a type of crude oil used as a benchmark in oil pricing); <sup>4</sup>Reuters/Jefferies Commodities Research Bureau Index

Figure 4

Spreads of Corporate Bonds to Treasuries Have Narrowed Significantly



Source: Bloomberg

Past performance is not indicative of future returns.

The strategy we formulated at the beginning of this year was to deploy cash first into the investment grade corporate bond markets, focusing mainly on high quality names (generally A-rated or higher). Meanwhile, we have also added to high yield corporate bonds: We view them as highly correlated with equities, while providing attractive coupons to offset any price declines. At the same time, we are maintaining underweight positions in treasuries and mortgage pass-throughs, because yields are unusually low, historically speaking.

Over the long term, we believe some investors may regard a composite index such as the Barclays Aggregate Index as flawed, due to the heavy weighting (approximately 70%) for government bonds and agency pass-throughs. One approach that could become popular is for investors to unbundle the components of the index and to customize their own benchmark<sup>1</sup>.

In regard to equities, we are not in the camp that dismisses the recent surge as a “bear market rally.” Our view is that the U.S. stock market was oversold when the S&P 500 index fell well below its replacement value, which we estimate to be in the 725-750 area. The ensuing rally partly reflects a slowing in the pace of economic decline and a lessening in worries about nationalization of the banking system. However, two considerations make us reluctant to add to equity exposure now. First, we no longer consider the market to be cheap with the index now above the 900 level. Second, the economic recovery is likely to be more muted than the traditional v-shaped ones, because of the problems in the financial system<sup>2</sup>. Our inclination, therefore, is to wait for a pullback before adding to our equity allocation.

From a strategic standpoint, we also look for equities to generate below-normal returns over the coming decade. One reason is that the rate of economic growth is likely to be below trend, as households rebuild savings, financial institutions de-lever, and regulators clamp down on credit expansion. Another reason is that we are uncertain about the Federal Reserve’s ability to keep inflation in check once the economy gains traction. Thus, while we do not foresee a return to the era of stagflation that plagued financial markets in the 1970s, the environment ahead is also unlikely to be as favorable as the “Great Moderation.”

<sup>1</sup>See Fort Washington Investment Advisors “The Unbundling of Fixed Income,” April 2009.

<sup>2</sup>See Fort Washington Investment Advisors “Turning Point for the U.S. Stock Market?” April 2009.



## Lessons for Investors

In light of all that happened, many investment professionals are left wondering what went wrong, and what they should do differently in the future. Our assessment is that the financial crisis, among other things, has demonstrated shortcomings in traditional risk control procedures that must now be buttressed. In this regard, we are mindful of the criticisms that have been levied against models that attempt to quantify risk through measures such as standard deviation or value at risk (VAR) and which assume that returns are normally distributed. From our perspective, however, it is also important to separate the *process* of making investment decisions from the *tools* that are used.

All told, there are three critical steps in controlling portfolio risk. The first step begins with an assessment of *macro price risk* – in which the goal is to identify markets that are significantly mispriced relative to underlying fundamentals. The second step is to assess *micro risk* at the individual security level and at the company level. The third and final line of defense is to construct well diversified portfolios to protect against losses that are inherently difficult to assess. Below we identify some of the key issues relating to each of these areas:

- *Macro price risk.* For the most part, the money managers who sustained the greatest losses were those that failed to detect the bubbles in the housing and credit markets. Even then, it was critical to connect what was happening in these markets with the exposures of financial institutions. However, it was difficult for investors to do so, because securitization clouded the picture and also because some institutions hid their exposures to toxic assets in off-balance sheet entities. Investors ultimately relied on regulatory bodies such as the Federal Reserve and SEC to monitor the activities of these institutions, but the regulatory bodies also failed to grasp the linkages.
- *Micro risk.* This area is the domain of research involving company analysis, credit risk and structural risks in complex securities. While some investment firms employ teams of analysts to conduct research in these areas, others ultimately outsourced the job of analyzing complex structures to the credit rating agencies. By now, it is abundantly clear that investment firms must conduct their own independent appraisal. Beyond this, however, we believe more comprehensive actions are needed to buttress traditional analysis of individual credits and structures. They include limiting concentrations of risk by sector (e.g., financials) and type of instrument (especially residential and commercial mortgage-backed securities), as well as assessing counterparty risks thoroughly.
- *Portfolio diversification.* Because even the most thorough analyses of macro and micro risks cannot capture all sources of potential loss, investment professionals ultimately must rely on diversification strategies to protect portfolios. Traditionally, this has been achieved through the inclusion of bonds, domestic equities that are managed in various styles, and international equities. Because correlations tend to spike during market sell-offs, however, the benefits of portfolio diversification are often missing when investors need them most. Furthermore, globalization and increased capital market integration has caused correlations among asset classes to rise significantly in the past two decades.

Weighing these considerations, we are now exploring ways to add new sources of diversification that include various hedging strategies, and we are continuing to look for the right mix of diversification (negative correlation) coupled with low fees and the potential for excellent risk adjusted returns.

Many alternative strategies that are marketed today carry with them large fee schedules and illiquidity, and as recent experience has shown, may be limited in their ability to diversify portfolios in down markets. Certain “Alternative Assets” (real estate, timber lands, metals, other materials) that gained favor in the early 2000’s appeared quite uncorrelated on the way up but then experienced the same spike in their downside correlations in 2008. While these assets did not move up in unison, they all moved significantly higher driven by increased leverage and the fear of shortages. The unwinding of credit, along with the rebuilding of consumer balance sheets (savings), and the illiquid nature of these investments led to a unified drop in demand and a consummate rapid decline in the value of all these assets.

We are constantly examining and modeling different asset allocation mixes, in an ongoing effort to participate in the upside moves as asset classes move from under-valued to fairly-valued, to over-valued while, at the same time, moving to limit exposure to the most extreme valuations. We are not market timers and we generally make modest tactical adjustments as



Fort Washington  
Investment Advisors, Inc.

---

we deem appropriate to our strategic allocations. We remain committed to the belief that the primary driver of investment returns is the strategic asset allocation and that a diversified allocation structured to meet a clients long term objectives is the best long term strategy. We continue to review and examine both our recommended “Strategic” and “Tactical” asset mixes in an effort to best serve our clients.

Diversification helps to preserve capital, can enhance returns by investing in asset classes that have attractive valuations, and we believe will serve our clients well over the long run. We must continue to examine the data to flush out those investment opportunities that zig when others zag in down as well as in up markets. As we move ahead through 2009 and look toward 2010, we will do so with a deeper understanding of how correlations behave, in both bull and bear markets and across asset classes. We have an ever increasing desire to ferret out those opportunities that will provide our clients with sound investment returns while limiting the downside risk of the portfolio.



Fort Washington  
Investment Advisors, Inc.

A member of Western & Southern Financial Group

303 Broadway, Suite 1200 • Cincinnati, OH 45202-4220  
tel 513.361.7600 • toll free 888.244.8167 • [FortWashington.com](http://FortWashington.com)