To enjoy the benefits of diversification with less discomfort, CIO should focus on the long-term growth trajectory of our overall portfolios. (UBS)

Diversification is the logical solution to an unpredictable future

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Nobel Laureate Harry Markowitz famously called diversification "the only true free lunch in investing." Diversification is immensely valuable, helping to boost risk-adjusted return potential and allow for smoother portfolio growth. However, the truth is that diversification is not entirely free. To harvest diversification's benefits, you must endure discomfort.

It's not a bug, it's a feature!

You can't enjoy all of diversification's benefits without also experiencing some discomfort:

- Diversified portfolios are constructed using asset classes that are driven by different underlying forces; therefore, their returns aren't perfectly correlated with one another.
- Because non-correlated investments' returns wax and wane at different times, the effect of extremely strong returns in one asset class will be tempered by modest (or even poor) returns in another part of a diversified portfolio.
- This interaction reduces portfolio risk per unit of return, allowing a diversified portfolio to enjoy a smoother path of growth. It also reduces the magnitude of drawdowns and allows for faster recoveries.

Diversification's benefits accrue over multiyear time frames, and they aren't always obvious over the short term. As a result, here are some common frustrations that diversified investors will face, especially if they look at their returns often:

I am underperforming [Asset X]!

Diversified portfolios will always underperform the best-performing asset class, and usually underperform several asset classes, but will never underperform all asset classes.

When one asset class is outperforming, hindsight bias tricks us into thinking that this outcome was inevitable and predictable; we often forget that periods of outperformance often follow lengthy periods of underperformance.

Why do I still own [Asset Y]?

There will always be something in the portfolio that seems like a “loser.” Short-term returns are rarely average, and usually fall either far above or far below the average return (with the spread being larger for higher-volatility asset classes).

This frustration is supercharged by the fact that returns tend to be “lumpy,” with asset classes experiencing multiyear periods of under- and out-performance. It's hard to keep patience with underperforming asset classes, but there's no viable alternative; if you give up on today's losers, there's a good chance you'll miss tomorrow's winners.

Diversification is boring!

A well-diversified portfolio is designed to perform well throughout a full market cycle, but there is no point during the cycle where being diversified will seem like the right choice; it will always feel like the portfolio is missing opportunities.

Individual asset classes will take turns being the “hero” or the “villain,” but the overall portfolio performance will always seem mediocre. That's the point.

The truth is that, if there's something in your portfolio that you hate, it's a good sign you're diversified. If you love every holding in your account, you may be taking more risk than you think.

More than the sum of its parts

It is inevitable that some of today's “winners” will become tomorrow's “losers” (and vice versa); after all, there is a reason we call them “market cycles.”

Unfortunately, millennia of evolution are working against us here. Our brains have evolved to find patterns, even in random noise. We also have a strong recency bias that leads us to favor newer information over older information. Unfortunately, these tendencies feed into one another, leading to performance-chasing behavior that results in manias, panics, and other drivers of poor performance.

Diversification is the logical solution to an unpredictable future. It allows us to benefit from the market's top performers while reducing the risk that our portfolios will be damaged when one asset class or set of stocks does particularly poorly. Diversification also allows us to benefit from portfolio management strategies such as rebalancing and tax-loss harvesting.

To enjoy the benefits of diversification with less discomfort, we should focus on the long-term growth trajectory of our overall portfolios. Maintaining a holistic perspective—and avoiding the randomness of short-term returns—can help us to reduce the urge to chase performance, keep us mindful of the bigger picture, and allow us to focus on the changes that are within our control.

To paraphrase Winston Churchill, diversification is the worst investment strategy…except for all the others

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