There Is Only One Way to See Things Rightly

What investors should consider when adding risky asset classes to their portfolios

Larry Swedroe

Steve Nash is the point guard for the NBA's Phoenix Suns. Looking at some of his statistics, they are pedestrian in many ways. For example, he has never averaged more than 19 points per game in any of his 12 seasons. Certainly there are those with far better statistics who many would consider better players. Yet, Steve Nash is a *two-time* MVP.

Nash won such accolades because his contributions go beyond his individual statistics. Nash's main contribution is that he makes everyone around him better players. This attribute is why Nash is generally considered one of the greatest point guards of his era. It also demonstrates why it is important to not view a player's value by viewing his statistics in isolation. One needs to consider how the player impacts the team's overall performance.

The same thing applies to investing. A common mistake made by investors and professional advisors is viewing an asset class's returns and risk in isolation. Just as the right way to consider the value of Steve Nash is to consider how his play impacts the entire team, the right way to view an asset is to consider how its addition impacts the risk and return of the portfolio.

In 1990, Harry Markowitz shared the Nobel Prize in Economic Sciences due to his contributions to Modern Portfolio Theory. Markowitz demonstrated that one could add risky, but low correlating assets to a portfolio and increase returns without increasing risk (or, alternatively, reduce risk without reducing returns). The following example demonstrates the point.

From 1991 through 2007, the S&P 500 Index returned 11.41 percent per annum and had a standard deviation of 17.0 percent per annum. During the same period the S&P Goldman Sachs Commodity Index (GSCI) returned just 6.80 percent per annum and had a standard deviation of 25.6 percent per annum. Why would anyone consider including in a portfolio an asset class that

experienced 4.61 percent per annum lower returns than the S&P 500 Index and also experienced greater volatility?

If you considered investments in isolation, that would not happen. However, a 95 percent S&P 500 Index/5 percent GSCI portfolio would have provided a slightly higher return (11.42 versus 11.41) with a lower standard deviation (15.9 versus 17.0), or a higher return with less risk. This outcome was a result of the impact of the negative correlation (–0.20) of returns of the two asset classes. (Negative correlation is when one asset produces higher than average returns, the other tends to experience lower than average returns.) Investors should prefer the portfolio that included the lower returning and more volatile GSCI. It is important to note that, given that investments in commodities are generally tax inefficient, one should only consider them if they can be held in a tax-advantaged account or if one is in a low tax bracket.

When considered in isolation, commodities appear to be a low returning, risky asset. Yet their inclusion has historically improved portfolio performance.

Summary

John Ruskin was a 19th century author, poet and artist who stated: "Not only is there but one way of doing things rightly, but there is only one way of seeing them, and that is seeing the whole of them." Ruskin's advice applies to investing. There is one right way to build a portfolio — by recognizing that the risk and return of any asset class by itself should be irrelevant. The only thing that should matter is considering how the addition of an asset class impacts the risk and return of the entire portfolio.
