HFS
Wealth Advisors
Serving Your Life & Legacy

Make Diversification Great Again - November newsletter

Make Diversification Great Again

The US equities market has experienced an incredible 15-year stretch. Historic even. Over that time, the S&P 500 Index ($SPX) is up around 14% annually, which is double that of stocks in developing countries, and three times that of investment grade bonds. (1) This impressive performance has created an environment where diversifying your portfolio towards other assets has led to consistent underperformance. This is clearly evidenced by Morningstar's tracking of 372 asset allocation portfolios, where over the last 15 years, exactly 1 of those 372 has come out ahead of $SPX. (1)

So, keeping that in mind, we can confidently say that diversifying your portfolio is a thing of the past, right? Well, not quite... It's important to remember that 15 years is a relatively short period of time for the market. What happened in the past 15 years is no great predictor of what will happen in the next 15. If I could predict today's stock movements based solely on yesterday's, I'd be a rich man. But, of course, it's not that simple. Past performance is no guarantee of future results, and in reality, it's not even a reliable predictor. For instance, the Morningstar star system bases its ratings on average past returns. (2) However, a Vanguard study in 2013 found that "an investor had less than a 50-50 shot of picking a fund that would outperform regardless of its rating at the time of selection." (3) The same applies to individual stocks. Research published by the Financial Times in 2024 shows how challenging it is for companies to consistently outperform, with only "an average of 15 companies per year [managing] to be in the top 100 [in returns] for two consecutive years." (4)

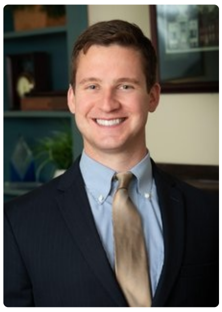
Diving deeper, let's take a look at the early 2000s. Between 2000 and 2015, diversified portfolios handily outperformed $SPX. During this time, stocks lost half their value twice, due to the Dot Com Bubble and the Great Financial Crisis. (1) Take a look at the following charts: The first shows $SPX (in green) vs. a 60/40% blend of $SPX and the Bloomberg Aggregate Bond Index ($AGG) (in orange) from 10/31/2009 to 10/31/2024. The second shows the same indices, but from 1/1/2000 to 1/1/2015. (5)

HFS Wealth Advisors
HFS Wealth Advisors

330-659-7140
hfswealthadvisors@hfswa.com
www.hfswa.com

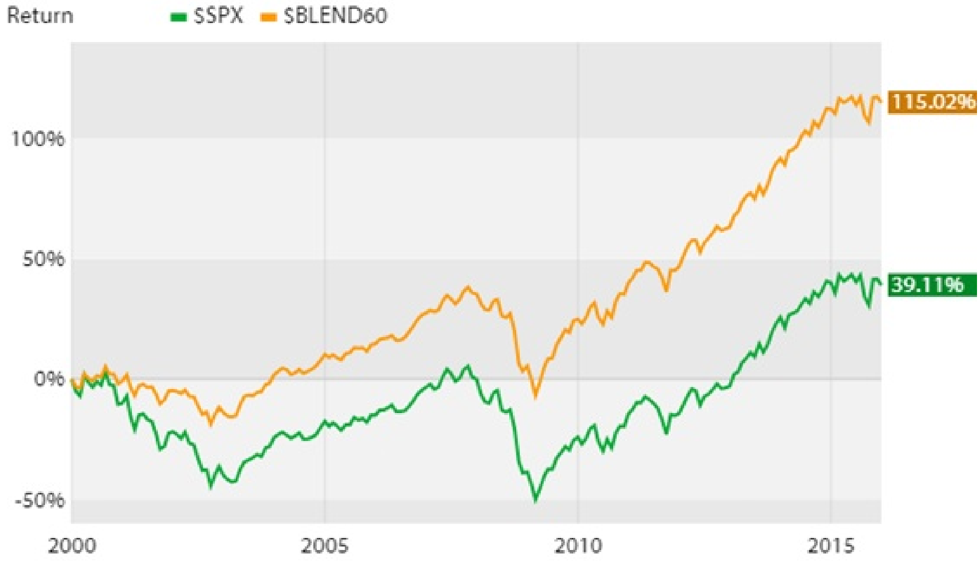
Patrick Hammer, MSFS, AEP®
Sr. Client Advisor and President Partner
330-659-7140
hfswealthadvisors@hfswa.com
www.hfswa.com

Todd Rohrer, C(k)P® AIF®
Client Advisor
330-659-7140
trohrer@hfswa.com
www.hfswa.com



Justin Hamlin, CFP®, AEP®
Client Advisor
330-659-7140
jhamlin@hfswa.com
www.hfswa.com

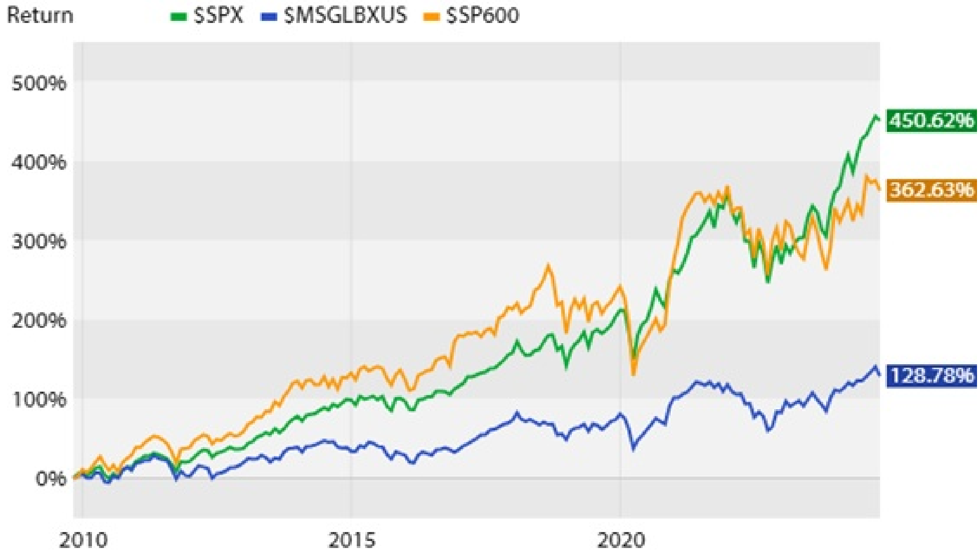
Schedule a meeting

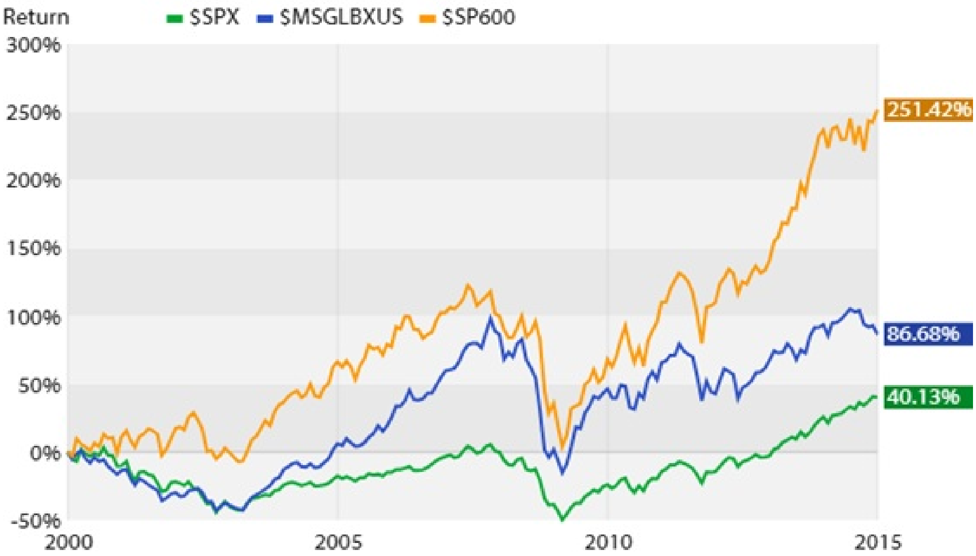


Suddenly, $SPX's 15-year dominance post financial crisis seems a little more unusual. But still, you might think, "who cares, if you just waited it out you would've been fine in the end." While that long-term style of thinking is typically sound when it comes to investing, in this case it fails to account for two things: first, that there weren't millions of people needing to access their investments during the period depicted in the second chart, and second, that waiting it out would've worked...

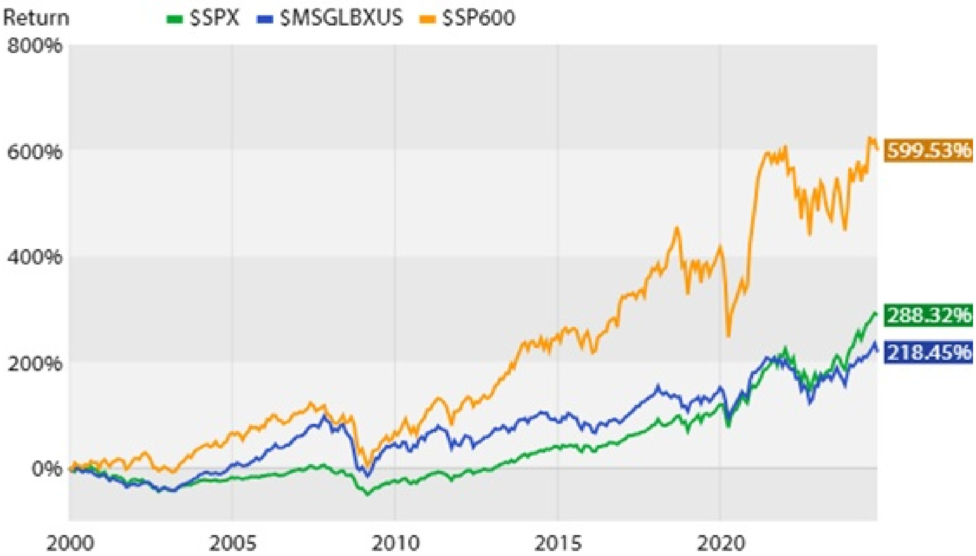
This chart once again shows the same indices, but it combines the two periods to show 1/1/2000 through 10/31/2024. (5) Even after outperforming for 13 of the past 15 years, (1) $SPX still hasn't caught up with a simple 60/40 portfolio.

As great as those three charts look for the efficacy of diversification, I must admit that there's more to the market than just US large cap stocks, and fixed income. Glaringly, all three charts ignore the entire international market, as well as US small cap stocks. The following charts aim to fix that, pitting $SPX (in green) against Morningstar's Global Markets ex-US index ($MSGLBXUS) (in blue), and the S&P 600 Small Cap Index ($SP600) (in orange), during the same periods as before: 10/31/2009 - 10/31/2024 and 1/1/2000 - 1/1/2015. (5)





Now the picture is really starting to come into focus. On one hand, there's been clear outperformance for US large cap stocks ($SPX) over the past 15 years. On the other, however, there was notable underperformance during the first 15 years of this century. When you combine those two timeframes together, despite how significant $SPX's recent overperformance has been, it only barely squeaks ahead of international equities, while still lagging behind US small caps, and as we saw previously, a simple 60/40 portfolio. (5)



The bottom line is that diversification works. Yes, there will be times when your undiversified neighbor is comfortably beating your returns. And yes, there will be times when it feels like diversifying was the wrong strategy. But ultimately, no one has a crystal ball to predict the next 15 years of asset performance; and to pretend that the past 15 years can accurately forecast the next 15 is both dangerous and misleading. I'll leave you with this sentiment from David Kelly, chief global strategist at JP Morgan Asset Management. He likens diversification to having a best friend on your worst day, saying, "The right asset allocation is a little bit like home insurance. You never know when you're going to need it, but you should never feel comfortable not having it." (1)

Written by: Ben Bulchik/Antonio Belmonte

1: https://www.bloomberg.com/news/articles/2024-06-10/great-bear-market-in-diversification-haunts-wall-street-pros

2: https://www.investopedia.com/articles/investing/013016/are-morningstars-best-mutual-funds-really-best-morn.asp

3: https://www.stat.berkeley.edu/~aldous/157/Papers/mutual_funds.pdf

4: https://www.ft.com/content/a9b53d71-3bd5-43dd-80ac-399957614374?segmentId=2c1df321-36a4-1206-2c08-112c059dd69d

5: Kwanti Analytics