December 09, 2023

# Market Memo

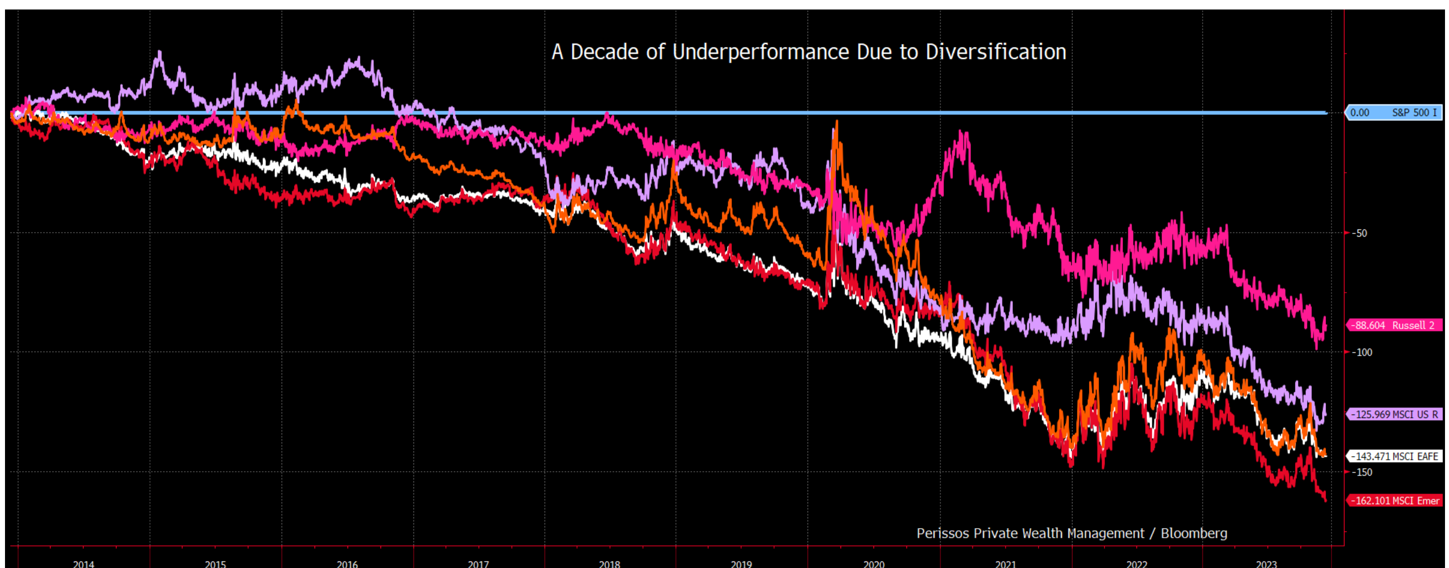
## Research and Insights

In my last memo (read it here), I described the asymmetrical nature of market returns this year. This year has been one of the most difficult years for a diversified portfolio. When comparing a portfolio to a benchmark, the key is to choose an appropriate benchmark that represents and has a similar allocation to the portfolio being analyzed. Most investors naively choose to compare their portfolio to the S&P 500.

The S&P 500 Index is made up of the 500 largest U.S. companies. Now, this would be an appropriate benchmark if the investor's portfolio was only invested in large U.S. companies, but most investors choose to diversify their portfolio among different asset classes and geographies. The objective is to diversify investments among noncorrelated assets in order to minimize the overall portfolio risk. You have heard me argue that diversification is not simply blindly investing in a bunch of different asset classes. Diversification is achieved when an investor can invest in assets that are not correlated with each other. In other words, if asset A moves up, asset B may move up or down but does not move in sync with asset A.

The issue with diversification is that by investing in noncorrelated assets, you run the risk of underperforming the overall stock market if your benchmark is, for example, the S&P 500. If an investor uses the S&P 500 index as their benchmark but they are invested in other assets such as International Stocks, Emerging Market Stocks, Commodities, Small Company Stocks, Real Estate, US Bonds, International Bonds, etc., and the S&P 500 index is the best-performing asset, their portfolio will underperform.

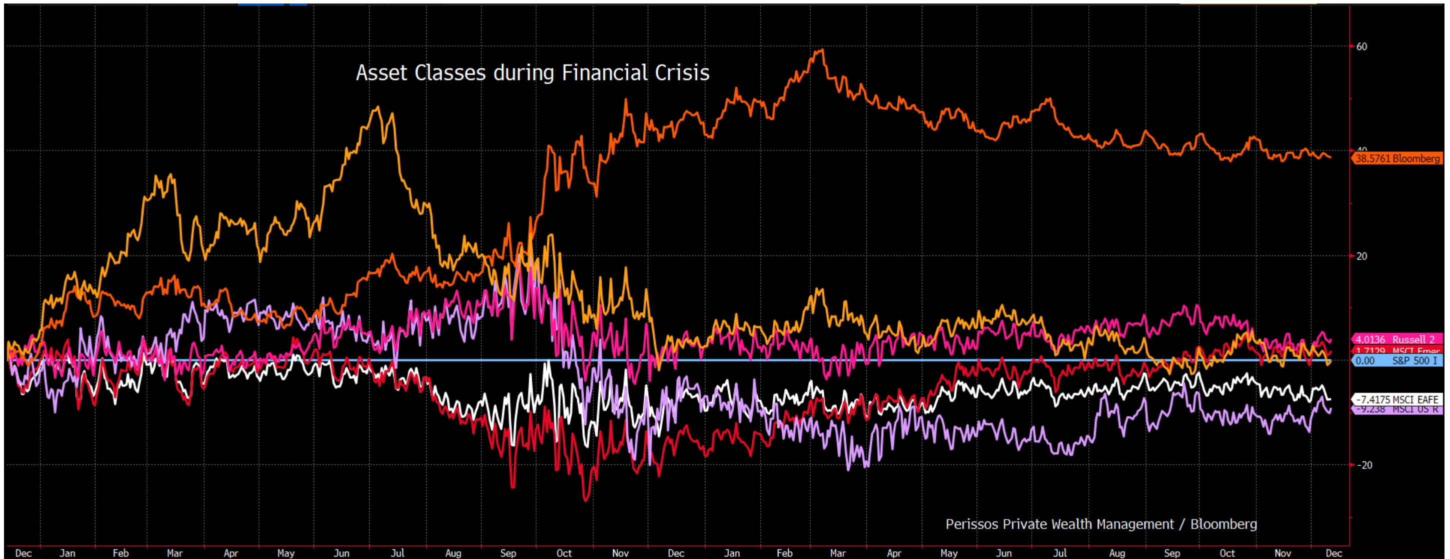
The chart below illustrates this issue well. I normalized the performance of different major asset classes compared to the S&P 500 over the last decade. As you can see, for the last decade, the S&P 500 has outperformed other major asset classes by a wide margin.



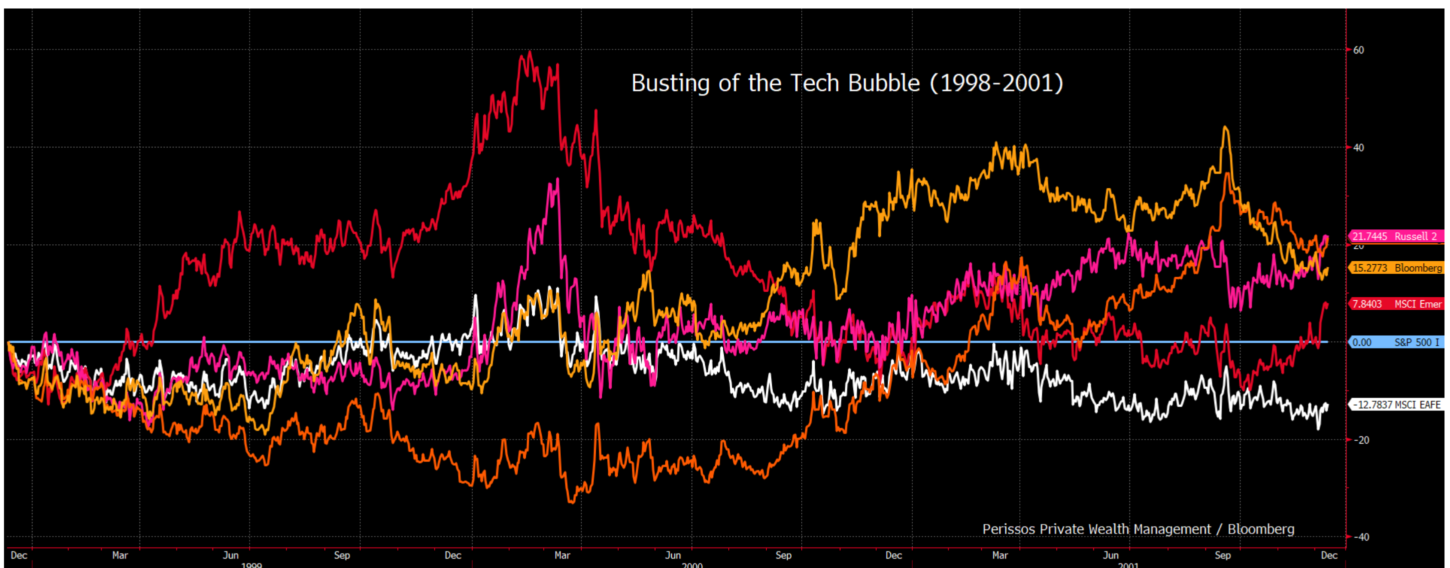
The asset classes used in the chart are:

- Russel 2000 Index (2000 mid and small-sized stocks)
- EAFE Index (Europe, Asia, and the Far East stocks)
- Bloomberg Commodity Index (represents a basket of commodities)
- Bloomberg Aggregate Bond Index (represents a basket of bonds)
- U.S. Real Estate (Real Estate stocks)
- Emerging Market Index (Emerging Market stocks)

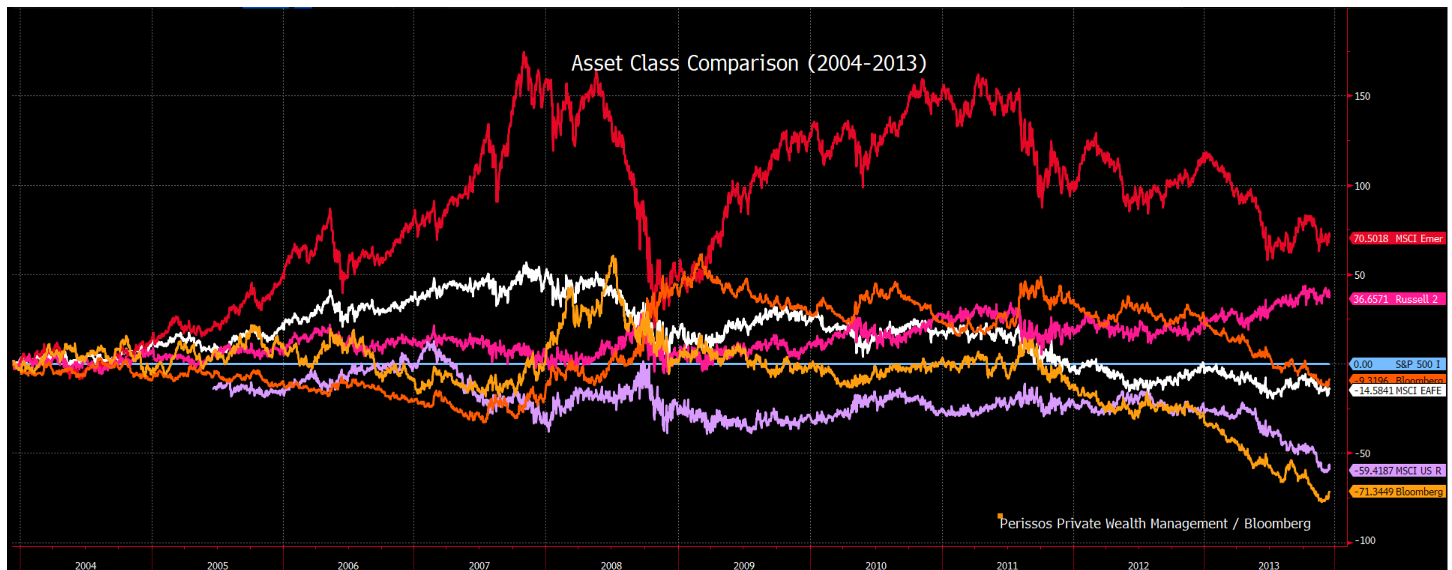
In today's economic environment, the S&P 500 and Technology stocks are outperforming everything else, so a diversified portfolio isn't keeping pace. However, there will be a time when the S&P 500 and Technology stocks underperform many of the other asset classes. If we look at the same asset classes but a different time period, we see drastically different results. The chart below shows the same asset classes during the Global Financial Crisis.




We can see that when normalized, the S&P 500 underperformed four of the six other asset classes. It is even more pronounced after the popping of the Tech Bubble in the early 2000s, shown below. The S&P 500 Index underperformed all but one asset class.



In the decade following the busting of the Tech Bubble (Jan. 2004-Dec. 2013), we saw Emerging Market stocks and International stocks outperform the S&P 500, as shown in the chart below.




For most of us, a decade feels like an eternity in relation to investing, and it can be difficult to maintain a disciplined investment approach. Hindsight is always 20/20, but it helps to look at other historical time periods to understand that the best-performing asset class this year, or even this decade, could be the worst-performing asset class over the next year or decade, which was the case for Emerging Market stocks. If you look at the above chart, you will see that Emerging Market stocks (the red line) were the best-performing asset class for the decade starting in January 2004 and ending in December 2013. If you then go to the first chart in this Memo, you will see that over this past decade, Emerging Market stocks have been the worst-performing asset class.

Just as it wouldn't have been a smart decision to invest a large portion of your portfolio in Emerging Market stocks in 2013, after a decade of outperformance, it may not be a smart decision to invest a large portion of your portfolio in S&P 500 and technology stocks today, just because S&P 500 and technology stocks have outperformed the others over the last ten years.

This memo is not a recommendation to invest in any of the asset classes described above; it is rather to demonstrate that what is doing well today may not do well tomorrow and that diversifying a portfolio is a prudent way to help manage risk over the long term. There are many different diversification methodologies, and since I have written in-depth about Perissos's approach in previous memos, I won't go into detail here. While diversification may make investors feel like they are missing out on higher returns, especially when they are comparing their portfolio to the best-performing asset class, it is still a prudent approach when the future is uncertain.

On another note, next Wednesday, the Fed holds its Federal Open Market Committee meeting, and Chairman Powell will address the current tightening cycle and answer questions about where rates are headed, giving the easing of inflation pressures. If he signals that the Fed may begin cutting rates soon, we will likely see interest rates continue to fall, but if he signals higher rates for longer, we could see a reversal in the downward trend in interest rates.

All my best,

Brandon VanLandingham CFA, CMT, CFP®

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