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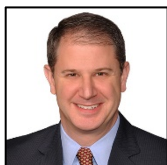

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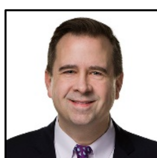

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Why diversify?

The S&P 500 is up an impressive 300% in this recent bull market, but investors should not dismiss the benefits of diversification.

Source: PMFA, Morningstar
As of 6/30/2019. Diversified portfolio consists of 42% Russell 3000, 18% MSCI EAFE, and 40% Bloomberg Barclays Agg (rebalanced monthly).

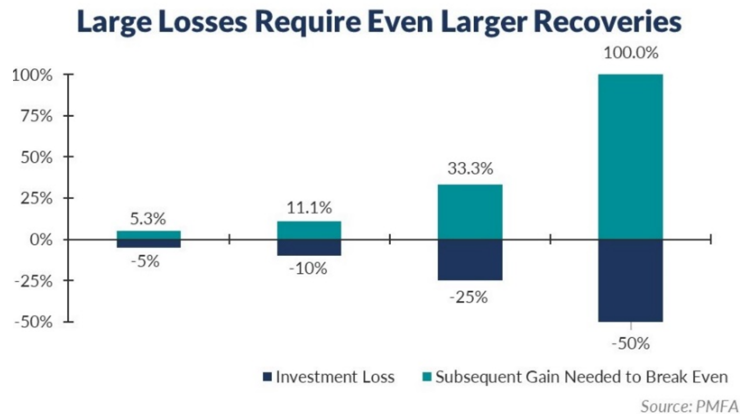
As U.S. stocks continue to climb to new highs, investors may begin to question the benefits of diversifying their portfolios. Since 2009, an investor holding only the S&P 500 would be up over 300%, while a moderate investor with a diversified mix would have gained roughly half of that return. This large divergence in returns may cause some investors to want to take on unnecessary risk in an attempt to capture those higher returns — but is it worth it?

Since the start of the century, a more diversified, moderate-risk portfolio has delivered a far smoother ride, while achieving just modestly lower returns than the S&P 500 over the nearly 20-year period. While the diversified mix lagged in up periods, it also dampened the drawdown experienced in bear markets, allowing investors to recoup losses faster (see accompanying commentary where we discuss the math of volatility).

Although strong equity returns may be enticing, chasing performance is often a losing strategy, and we believe investors would be remiss to dismiss the benefits of diversification today. While risk tolerance, time horizon, and investment goals are unique to each investor, we believe defining a plan and maintaining the discipline to stick to it remains a critical component to a successful investment strategy.

How do losses impact portfolio performance?

Fear of missing higher returns may cause investors to increase risk. However, limiting downside can be just as important as upside participation.



Given the strong returns of domestic equities over the past 10 years, investors may be considering shifts to a more aggressive risk profile and reducing exposure to other segments of the market. However, while maximizing upside is the goal for every investor, lessening drawdowns can be just as impactful to long-term performance.

The chart above illustrates the math of volatility, showing that the greater the loss experienced, the larger the gain that is needed to bring the portfolio back to its original value. In order to just break even, a 5% loss requires a 5.3% gain, a 25% loss requires a 33.3% gain, and a 50% loss requires a 100% gain. There's no question that U.S. large cap stocks have dominated in this recent bull market, but they have also experienced meaningful sell-offs over the last 20 years. Shifts in market dominance are inevitable, as top performers take their turn near the bottom of the pack, and key to why diversification works.

Maintaining a diversified approach can help to mitigate the downside in market sell-offs and provide a smoother ride for investors to achieve their goals. Less volatility also helps investors to stay in the game and not abandon one's strategy at the worst possible time. Ultimately, we caution against dismissing the benefits of diversification today.

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.
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