# Diversification is Needed Most When it is Appreciated Least

westwoodgroup.com/weeklyblog/missive-on-a-momentous-market-mountaintop/

Both the S&P 500 and the Russell 2000 smallcap indices hit new all-time high levels on Friday. This is the first broad market high since the S&P 500 last peaked earlier this year on January 26. The S&P 500 has now risen about 9 percent this year, even with numerous news and economic events causing sharp market volatility since late-January. Many market catalysts arose from positive news on the economic front, but many more market moving events were caused by negative stories in the 24-hour news cycle. The market has looked through the potential for a global trade war, threats of rebounding inflation and a daily cacophony of chaos coming out of Washington D.C. Strong growth in corporate profits, 40-year highs in both consumer and business confidence and record-low unemployment have formed the foundation that new market highs have been built on. Growth in corporate profits is the one thing that consistently drives equity market returns higher, and we have seen that laser-focus on continued strong economic numbers pay dividends for the equity market this year.

Some have noted that this nine-year-and-counting bull market is the most unloved bull market in history, as each new high has sparked investor worries about impending financial doom from such lofty market highs. If you were to Google “the market just hit an all-time high, is it time to sell?”, you will find hundreds of stories and commentaries addressing this worry, and the range of stories have publication dates evenly dispersed in every year going back to 2010. While investor angst may be high today, it seems as if many continually cantankerous investors have been waiting for the stock market to crash from every new high since the Great Recession of 2008 ended.

Negativity always sounds more robust and reasoned than outright optimism does, and there will always be a morbid mob of pundits and prognosticators that fear each new all-time high and want you to feel that fear as well. However, there is nothing inherently dangerous about new market high levels. Looking back at all new all-time market highs since 1928, the average return from a new market high over the next six months is a gain of 3.9 percent vs. 3.6 percent on all other days. Over the next year from an all-time high, the market gained 7.8 percent versus 7.5 percent on all other days. Therefore, market performance is better than average following all-time highs, not worse. This fact is not mentioned in any of the “the sky is falling!” articles, however.

Conversely, while a continually strong equity market does produce worry in some investors, in others it may create the opposite mindset. Over time, a well-diversified long-term wealth plan has proven to be the best bet to weather any market cycle storm. However, strong stock market periods like this one may cause well-meaning long-term investors to question the wisdom of investing in a wide variety of strategies and asset classes, rather than just holding stocks. With U.S. largecap company stocks outperforming other asset classes so dominantly lately, an investor may forget about their plan, the risk and the downside potential. An investor may be inclined to ask, “Why don’t we just own U.S. largecap stocks and call it a day?” In positive markets, it can be easy to forget why it is the investor’s long-term interest to own a variety of strategies such as bonds, REITs, emerging market stocks, international stocks, small and midcap stocks, and cash.

The idea that all these strategies and asset classes do not move together in lockstep is exactly the point of developing a thoughtful long-term wealth management plan. It is what keeps investors from experiencing the full pain of an inevitable stock market correction when a recession does occur. And diversification is especially essential at times of market extremes. Many investors remember that the S&P 500 lost 39 percent of its value in 2008, but few recall that the 10-year government bond *gained* 21 percent in 2008. While the 10-year bond may not be an exciting investment vehicle nor its yield a titillating topic at a cocktail party, a balanced portfolio of both stocks and bonds held up much better in that challenging market year of 2008 than holding stocks alone.

Many investors may now question their emerging market holdings when looking at the sector’s loss of 6 percent so far in 2018. They may also remember that emerging market stocks lost 53 percent in 2008. But few investors recall that emerging market stocks gained 40 percent in 2007, 79 percent in 2009 and 38 percent in 2017. Many investors may scoff that REITs have only gained 1 percent in 2018, but few remember that REITs averaged yearly gains of 19.1 percent over the six-year period of 2009-2014. With paltry returns in the corporate high yield bond market this year of 0.1 percent, it may feel like it is time to sell those bonds and buy more stocks. However, the inclusion of high yield bonds in a well-diversified wealth management plan has paid off during the current market cycle, with the group's average yearly return of 10.8 percent since 2009. With huge technology companies like Amazon, Facebook and Google now household names, why would we want to hold midcap stocks? Because even with their smaller company size, the group has averaged a 17.6 percent average yearly gain over the past nine years.

During happy times in the stock market, it can be easy for an intelligent investor to forget why he or she would want to continue to hold a well-diversified portfolio of strategies and asset classes. Much like a sports team or Broadway play, each contributor plays a different but pivotal role in the overall performance, and each plays that role only at the appropriate time. This diversification is essential in riding out the ebbs and flows of global economic cycles. With a diversified asset allocation plan, some asset classes or strategies will always seem boring or unessential at times. This is how we know that we are managing downside potential. This is how we know that our financial legacy is not at risk. And this is how we know that we are positioned to prosper through any inevitable market downturn or market chaos.