An Oldie but a Goodie: The Global Balanced Portfolio

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In hosting a recent *virtual study group* with a few select advisors, one advisor kept having to leave the discussion because she had so many Amazon packages being delivered. Another kept having to excuse himself because the show his kids were watching on Netflix was playing too loudly in the background. This sparked a discussion among all of us about the influence that these tech companies have—both in our current lives and in markets. We all agreed that it's remarkable how a handful of large companies can consume our attention spans and wallets to such a degree.

This conversation isn't new; it usually comes up *after* periods of market volatility. When the S&P 500 continuously goes up, advisors tell me their clients are happy investing into the market through a passive index fund. But when markets go down, some clients start asking for defensive, actively managed strategies that look for opportunities outside of the U.S. to potentially lower risk.

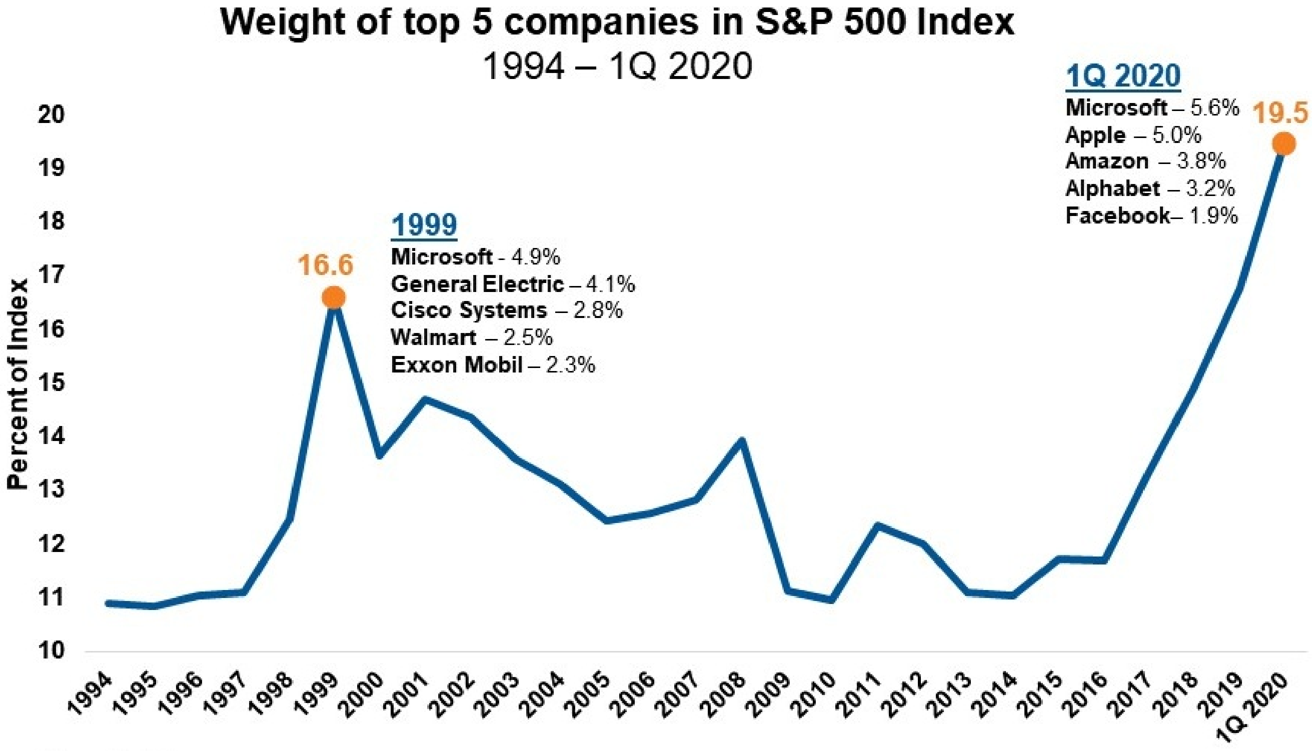
My colleague Joe McNally explored this topic in a previous blog, *You can't retire on a benchmark* Joe examined the challenges our industry has created by focusing too much on benchmark returns—and in this case, one focused on the 500 largest publicly traded U.S. companies—versus helping clients reach their desired outcomes.

Concentrated line-up

Let's look at the risk present in chasing the S&P 500 index because of the concentration of a few large companies.

Click image to enlarge

Concentration of S&P 500 exceeds late 90s



Source: Factset

Weights based on year end values

Alphabet represents both A&C share classes

As illustrated in the chart below, the top five capital-weighted stocks in the S&P 500 today now represent around 20% of the market cap. The last time the top five stocks had this type of capital weighting was in 1999 at about 18%—before the tech bubble burst. Microsoft is the only stock still represented in this statistic 20 years later.

Not surprisingly, the question many investors face today has become:*Are you paying too much for the remaining 495 stocks you own?* If a small concentration of stocks represents 20% of the index 20 years later, do you carry the risk of owning more losers along with the winners over the long haul?

As the market cap weighting increases in the S&P 500, the narrow leadership of growth drives most market returns. The potential risk in a client's portfolio is the market volatility resulting from the top five stocks representing 20% of the market selling off. That's adding insult to injury.

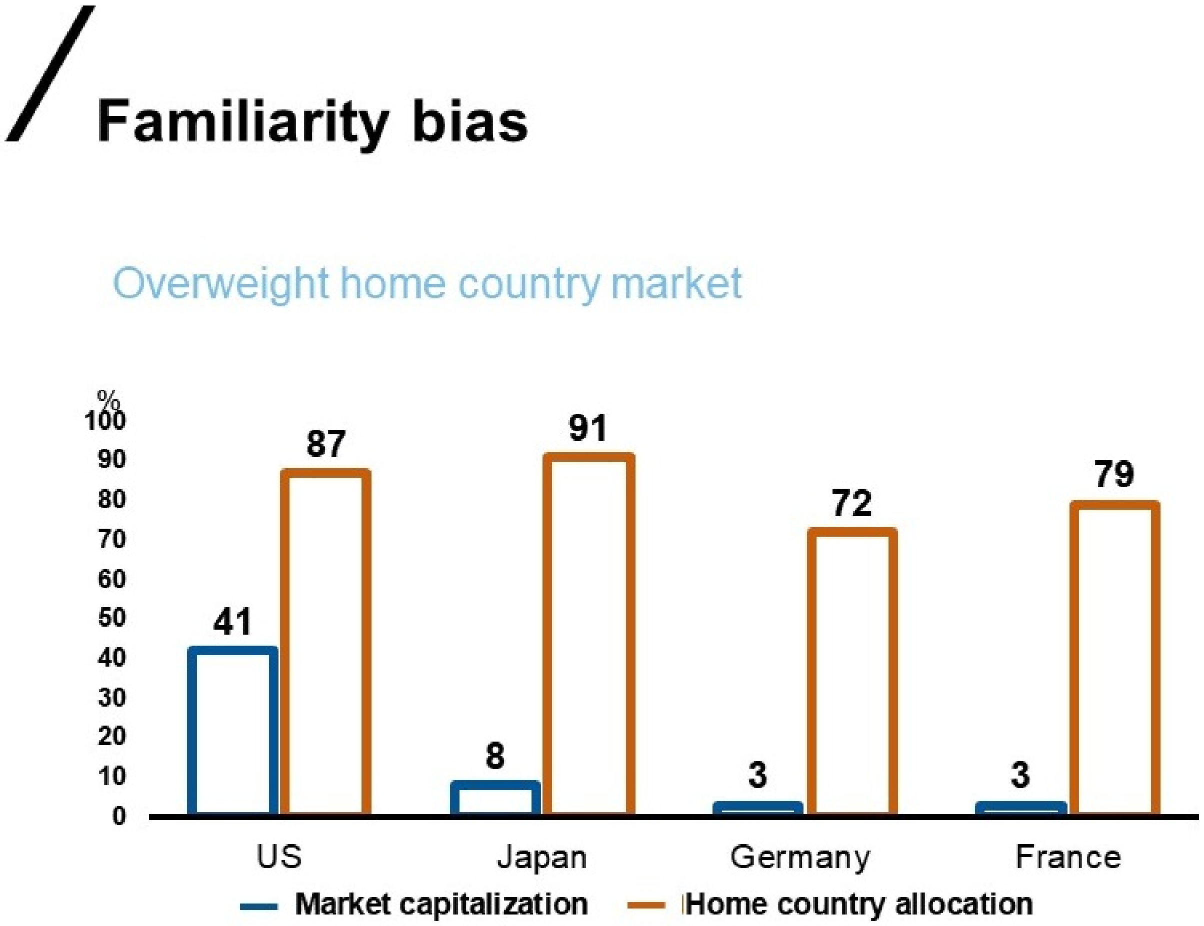
Getting too familiar: Buying what you know

Humans prefer what is familiar or well-known. Since sheltering-in-place, many of us may be using more Amazon and Apple products. The same holds true for investing: many investors prefer stocks based in their own country. This home-country bias may show up well in our investment portfolios.

While investors may be familiar with the products a company provides, they may be less familiar with the investment fundamentals of the stocks themselves. For example, the market capitalization of Amazon is $1.2 trillion, with a trailing price to earnings (P/E) ratio of 115.[1] Apple's market capitalization is $1.3 trillion with a P/E ratio of 25.[2]

Moreover, home-country bias limits the amount of diversification in investor portfolios and exposes investors to significant country-specific risk. Investors who diversify their portfolios tend to represent global market capitalization better.

Click image to enlarge



Source: Market capitalization of domestic listed companies (2017, in current USD)---World Bank https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?view=map Accessed on May 15, 2019. Home country equity allocation—John R. Nofsinger, The Psychology of Investing, Fifth Edition, Pearson, 2014, p. 89.

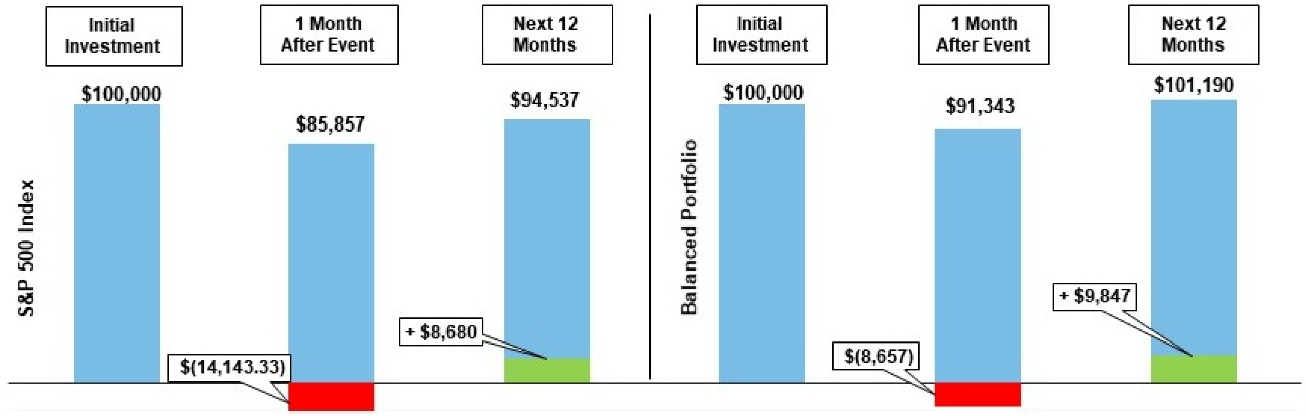
The case for the balanced portfolio

An advisor I work with frequently shares an example of two types of investors. One investor chases the S&P 500 market returns, both up and down. The other investor is in a diversified portfolio, focused on the long-term and not moved by short-term market moments. Let's look at these two investors' hypothetical $100,000 portfolios over time (see below). By taking the average return one month after a market-moving event, the balanced-portfolio investor only loses $8,657, relative to the S&P 500 losing $14,143. If you then take the average return starting one month after the event, a balanced portfolio actually gains $9,847, relative to $8,680 gained by the S&P 500. This leads to a balanced portfolio holding up much better during negative market events, while also gaining more, given its diversification.

Click image to enlarge

Average market pullbacks

S&P 500 Index v. Balanced Portfolio



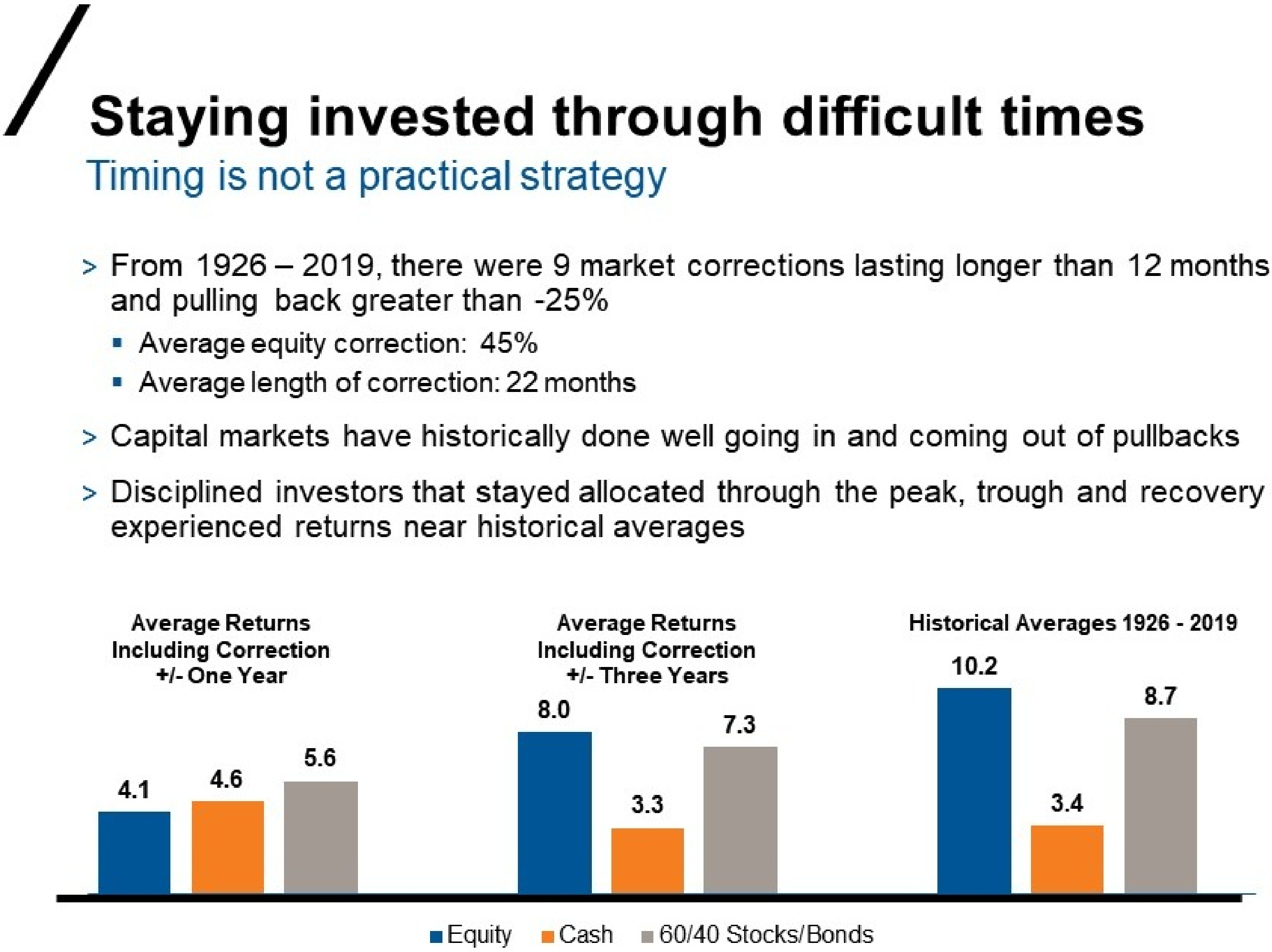
		S&P 500		Balanced Portfolio	
Pullback	**Date**	1 Month after	12 Months after	1 Month after	12 Months after
1987 Stock Market Crash	10/19/1987	-21.5	10.1	-7.8	15.7
Iraqi Invasion of Kuwait	8/2/1990	-8.9	26.9	-6.3	18.1
Long-Term Capital Management Bailout	9/23/1998	4.1	22.3	1.04	12.5
September 11 Terrorist Attacks	9/11/2001	0.59	-21.5	0.63	-8.3
Lehman Bros. Bankruptcy	9/15/2008	-27.3	12.8	-18.03	15.7
COVID – 19	2/20/2020	-31.8		-21.5	
Average	-	**-14.1**	**10.1**	**-8.7**	**10.7**

Source: Morningstar Direct – S&P 500 Index, Balanced Portfolio - BBgBarc US Agg Bond TR USD 40%FTSE Nareit Equity REITs TR USD 10/19/1987-2/18/2005 then FTSE EPRA Nareit Developed NR USD 2/18/2005-3/31/2020 4% MSCI EAFE NR USD 17% Russell 1000 TR USD 34% Russell 2000 TR USD 5%. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

Staying invested

A balanced portfolio over time can help smooth out the investment experience. As you can see from the exhibit below of historical averages from 1926-2019, a balanced 60/40 global stock/bond portfolio has provided competitive returns for investors who stay invested during turbulent markets.

Click image to enlarge



Source: US Equity: Ibbotson 1926– 1978, Russell 3000 Index 1979-2019, Fixed Income: Ibbotson 1926 – 1978, Bloomberg Barclays Aggregate Index 1979-2019, Cash: Ibbotson 1926 – 1978, Citigroup 1- 3 Month T-bill Index 1979-2019 Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

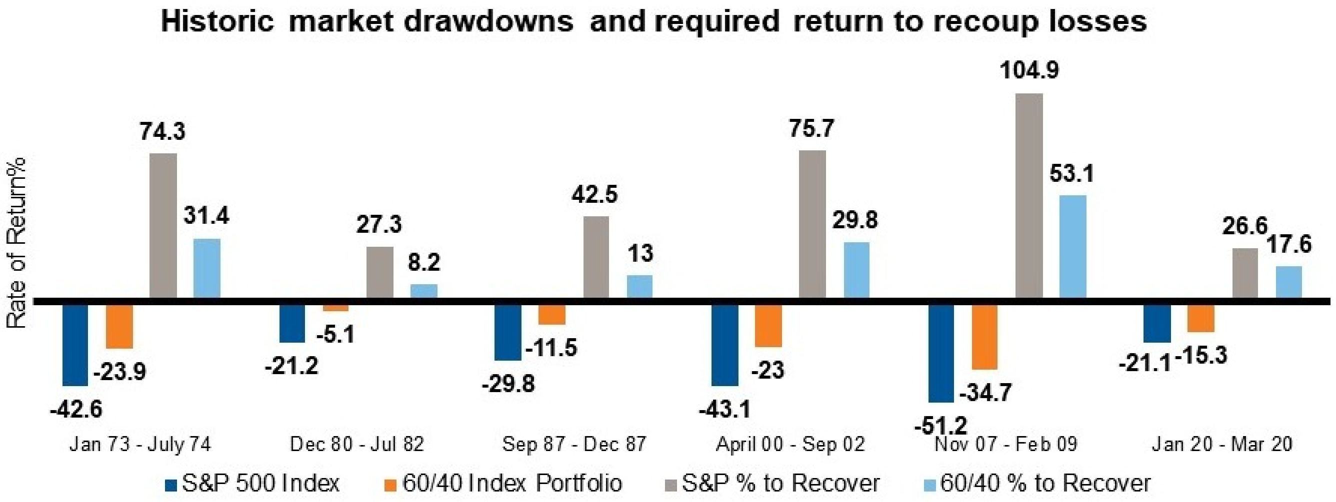
Diversification may mute the downside

When the market (as measured by the S&P 500 Index) went down 21% between January and March of this year, it was the drop that made the headlines. During the same period, a balanced portfolio was down 15.3%, as shown below. We all desire the market returns when things are going up, but not on the way down. A more diversified portfolio may help reduce the downside risk—and resulting pain—during historic drawdown periods.

Click image to enlarge

Don’t mistake the market for your portfolio

Diversification may mute the downside



- Equity drawdowns make the headlines
- Diversified portfolios soften the portfolio loss and reduce the climb back to pre-drawdown levels

60/40 Index Portfolio: 60% MSCI World Index/ 40% Bloomberg Barclays Aggregate Index. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

The bottom line

As financial markets remain unpredictable, a trusted financial professional can help:

1. Provide education on potential biases that may be affecting investment decisions
2. Create a process that considers an investor’s goals, circumstances and preferences to keep them focused on long-term outcomes

During these uncertain times, helping clients appreciate *an oldie but a goodie*—the balanced portfolio—while also objectively recognizing biases that could lead to poor investment decisions are tasks paramount to an advisor’s role. And that’s why we believe advisors have arguably never been more vital than today.

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[1] Yahoo Finance as of 28 May 2020
[2]Yahoo Finance as of 28 May 2020

Disclosures

Bloomberg Barclays U.S. Aggregate Bond Index: An index, with income reinvested, generally representative of intermediate-term government bonds, investment grade corporate debt securities, and mortgage-backed securities. (specifically: Barclays Government/Corporate Bond Index, the Asset-Backed Securities Index, and the Mortgage-Backed Securities Index).

Citigroup 1-3 Month T-Bill Index: An unmanaged index that tracks short-term U.S. government debt instruments.

FTSE NAREIT: An Index designed to present investors with a comprehensive family of REIT performance indexes that span the commercial real estate space across the U.S. economy, offering exposure to all investment and property sectors. In addition, the more narrowly focused property sector and sub-sector indexes provide the facility to concentrate commercial real estate exposure in more selected markets.

FTSE NAREIT all Equity Index: Measures the performance of the commercial real estate space across the U.S. economy offering exposure to all investment and property sectors.

FTSE EPRA/NAREIT Developed Index: A global market capitalization weighted index composed of listed real estate securities in the North American, European and Asian real estate markets.

MSCI EAFE (Europe, Australasia, Far East) Index: A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI World Index: A broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries.

Russell 1000® **Index**: A subset of the *Russell* **3000 Index**, represents the *1000* top companies by market capitalization in the United States.

Russell 2000® Index: measures the performance of the 2,000 smallest companies in the Russell 3000 index.

Russell 3000® Index: Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The S&P 500® Index: A free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500® are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.

Trailing price-to-earnings (P/E) is a relative valuation multiple that is based on the last 12 months of actual earnings. It is calculated by taking the current stock price and dividing it by the trailing earnings per share (EPS) for the past 12 months.

Forward price to earnings (forward P/E) is a quantification of the ratio of price-to-earnings (P/E) using forecasted earnings for the P/E calculation.

Cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation. As such, it is principally used to assess likely future returns from equities over timescales of 10 to 20 years, with higher than average CAPE values implying lower than average long-term annual average returns.

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