Defending Diversification *in a Bull Market*

By Daniel Wilderman, CEO, CIO | **April 26, 2021**

2020's stock market rotation is a reminder that what's in favor can change quickly

With current high valuations and a recent market pivot, future returns are likely to look much different

The traditional 60/40 portfolio faces threats in the decade ahead

Private securities strategies with professional management may be the answer

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EXECUTIVE SUMMARY

- 2020's stock market rotation is a reminder to investors to adhere to a diversified portfolio – what's in favor can change quickly
- US large cap growth stocks were the big winners over the last decade, but current high valuations and a recent market pivot to small caps and sector rotation means future returns are likely to look much different
- Interest rates at historically low rates and increasing inflation expectations threaten the traditional 60/40 portfolio in the decade ahead
- Private securities strategies with professional management can help investors in today's high P/E domestic stock market and low-yielding fixed income environment

IN THIS ARTICLE , WE ADDRESS WHY WE BELIEVE NOW IS THE RIGHT TIME TO REEVALUATE YOUR CLIENTS' DIVERSIFICATION.

A 60% STOCK AND 40% BOND ALLOCATION MAY HOLD GREATER RISK GOING FORWARD.

Diversifying your clients' portfolios nearly always means having to apologize for underperformance during a bull market; it's impossible to be in the winner's circle for years on end. Only after several market cycles can your clients appreciate the benefits of diversification. Outperformance may shift from US to international stocks, from growth to value, and from large cap to small cap, among other investment factors, however these shifts often take years or longer.

Private securities, when added to a diversified portfolio of stocks, bonds, and cash, have proven successful in further reducing a portfolio's risk. Diversification, along with rebalancing, has achieved strong risk-adjusted returns through the decades.

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1 2020'S "STAY AT HOME" TRADE AND ROTATION – A MICROCOSM OF DIVERSIFICATION

"Large cap growth is the only game in town." How often did we hear that over the last several years? Yet, small caps hammered large caps over the last year and are about even with large caps over the last five years as illustrated by the recent surge in the Russell 2000.

The huge rally in US small caps since March of 2020, and particularly since last November, caught many money managers and advisors flat-footed. Mega cap technology-related stocks (the notorious "FAAMG" companies) appeared to be the big winners of the COVID pandemic, from both pure returns and the narrative standpoint.

How easy was it to tell the story of technology and online companies coming out ahead during the pandemic? It made so much sense. Coronavirus-induced lockdowns kept consumers inside, hurting brick and mortar businesses while boosting online retail, home improvement, virtual-business, and in-home fitness equipment companies.

The losers were also easy to spot: restaurants, hotels, casinos, cruises, airlines, many niche REITs, and the whole energy sector. Take a look at Figure 1 on the following page.

The Amplify Online Retail ETF (IBUY) sharply outperformed both the S&P 500 SPDR ETF (SPY) and the Invesco Dynamic Leisure and Entertainment ETF (PEJ) from the February peak through early November.

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AS INVESTORS INITIALLY RESPONDED TO THE PANDEMIC, WE SAW RELATIVE STRENGTH IN ONLINE NAMES AND WEAKNESS FROM IN-PERSON STOCKS. OVER TIME, HOWEVER, MONEY BEGAN TO MOVE INTO THE MARKET'S BEATEN-DOWN NICHES.

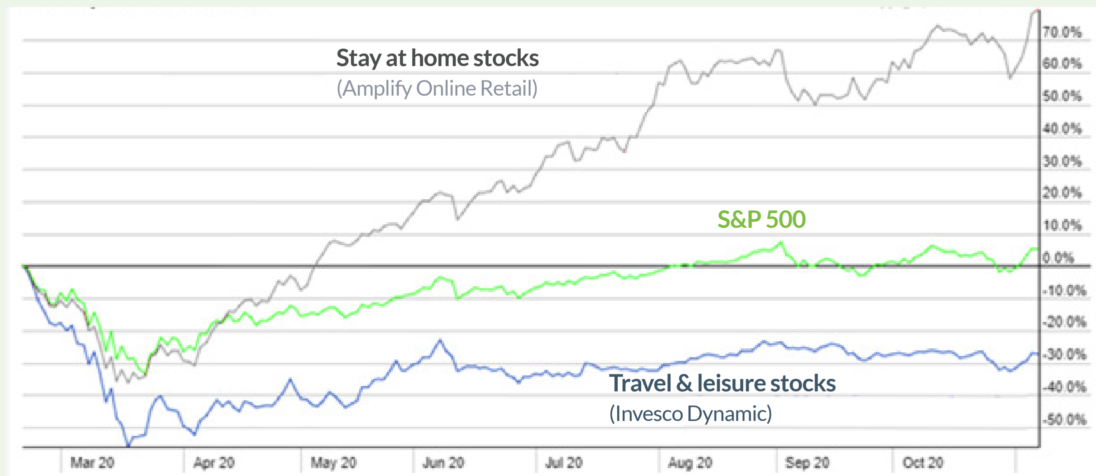

Figure 1 | Online Retail (IBUY) vs. Travel & Entertainment (PEJ) vs. S&P 500 (SPY) | February 2020-November 6, 2020[1]

Source: Stockchart.com

Style Shift

The regime changed during Q3 and Q4 2020; it didn't happen overnight though. Sector rotation played a key role in the rally off the March 23rd bottom. Big cap tech stocks (including Google and Facebook in the Communications Services sector and Amazon in the Consumer Discretionary sector) underwent a correction from Labor Day through mid-March 2021, while small caps and value stocks showed signs of life.

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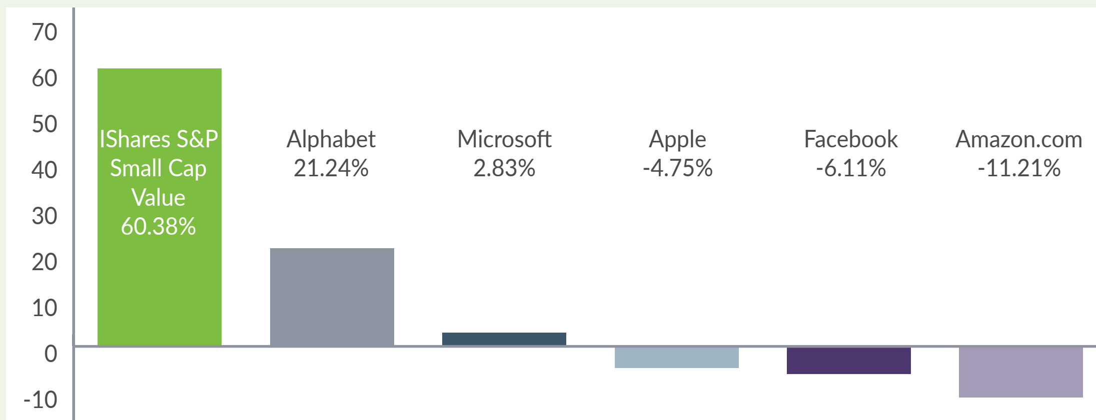

Figure 2 | US Small Cap Value Versus The "FAAMG" Stocks | September 2, 2020 to March 17, 2021[2]

Source: Stockchart.com

But what does a single year's stock market story have to do with long-term portfolio diversification?

2020's equity market rotation clearly illustrates how longer-term and broader cycles work. Money moves from one corner of the investment universe to another. What worked in early 2020 did not work so well in late 2020 and early 2021, much like how what was hot in the 2010s is unlikely to provide continued robust returns over the next 10 years.

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2 INTERNATIONAL OPPORTUNITY

US stocks crushed foreign equities for more than a decade. The S&P 500 returned an annualized 9.9% from 2006 through 2020 while the All-Country World Index (Ex-US) compounded at just 5.4%.[3] As a result, retail investors today are focused on the S&P 500 and Total US Stock Market Index. Unfortunately, it's easy to picture a new plan participant selecting 401(k) investment options simply going with what has worked in the recent past – US stocks. It's a risk many investors are taking today. Implementing a strong diversification strategy is needed to avoid such over-exposure to today's expensive domestic stocks.

THANKS TO RECENCY BIAS AND HOME BIAS, DOMESTIC INVESTORS INDEED ARE OVERWEIGHT US LARGE CAP EQUITIES.

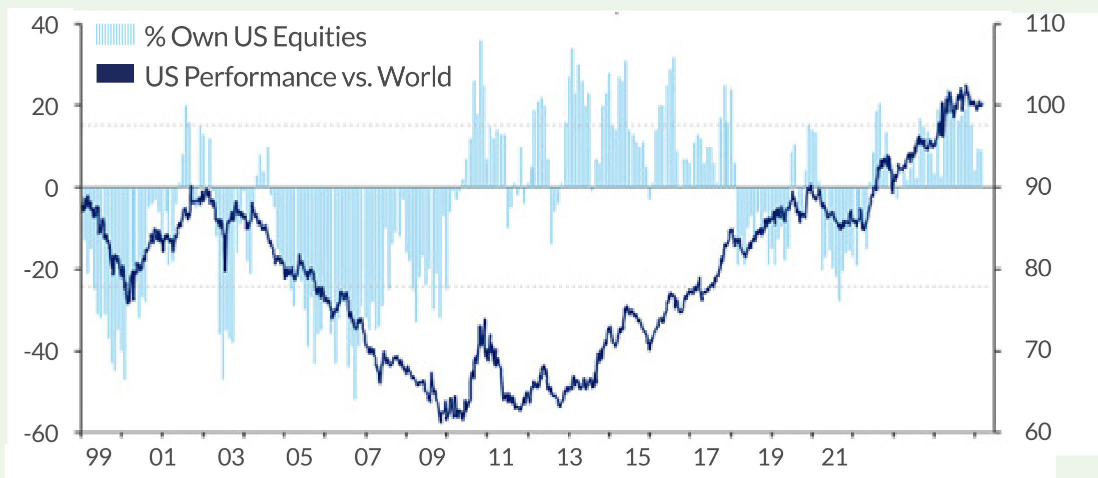

Figure 3 | Investor Regional Equity Allocation to U.S. Equities | March 2021[4]

Source: BofA Global Fund Manager Survey, BofA Global Research

Thanks to recency bias and the home bias, domestic investors indeed are overweight US large cap equities, according to the January/March 2021 Bank of America Global Fund Manager Survey chart above.

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Why are there different return characteristics between US and ex-US stocks? Look to the sector exposures.

As of December 31, 2020,[5] US equities made up 57% of the MSCI All Country World Index, a figure at the high end of its historical range. Domestic equities have continued to do well versus their international brethren despite weakness in the US Dollar Index since Q2 2020. Foreign markets feature a very different sector composition relative to the US equity market.

SOME OF THE BIGGEST DIFFERENCES IN FOREIGN VS. DOMESTIC MARKETS ARE SEEN IN EXPOSURE TO INFORMATION TECHNOLOGY AND FINANCIALS, SUGGESTING IT'S BEEN MORE OF A GROWTH VS. VALUE STORY VERSUS A CURRENCY NARRATIVE. *HOWEVER, THE TIDE COULD BE TURNING.*

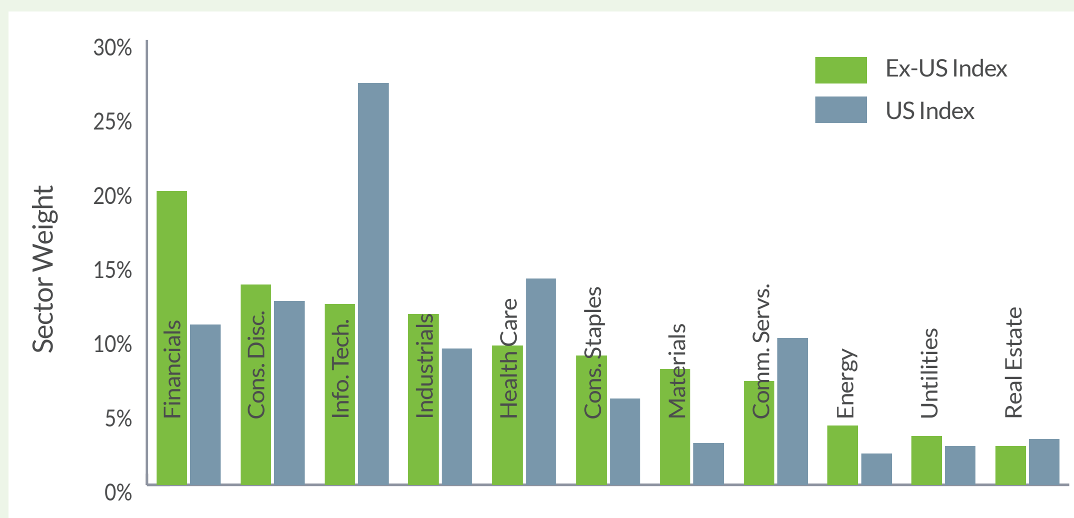

Figure 4 | Ex-US vs. US Sector Weights | June 2020[6]

Source: MSCI. Subject to change.

We've seen green shoots since Q4 2020 for the seemingly left-for-dead value and cyclical sectors. Ex-US stocks could experience significant outperformance if the market continues to rotate toward both small caps and the value and cyclical sectors like Financials, Energy, and Industrials. Rising commodity prices fit the narrative, too.

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While it seems like ages ago, the 2000-2007 period featured a weakening US Dollar, rising interest rates, and increasing commodity prices. There are signs that this early-mid 2000's regime could be coming back as interest rates and commodity prices rise. In times like these, it is easy to see the benefits of asset allocation and diversification.

EXPOSURE TO INFORMATION TECHNOLOGY AND FINANCIALS ACCOUNT FOR SOME OF THE BIGGEST DIFFERENCES IN FOREIGN VS. DOMESTIC MARKETS. HOWEVER, THE TIDE COULD BE TURNING.

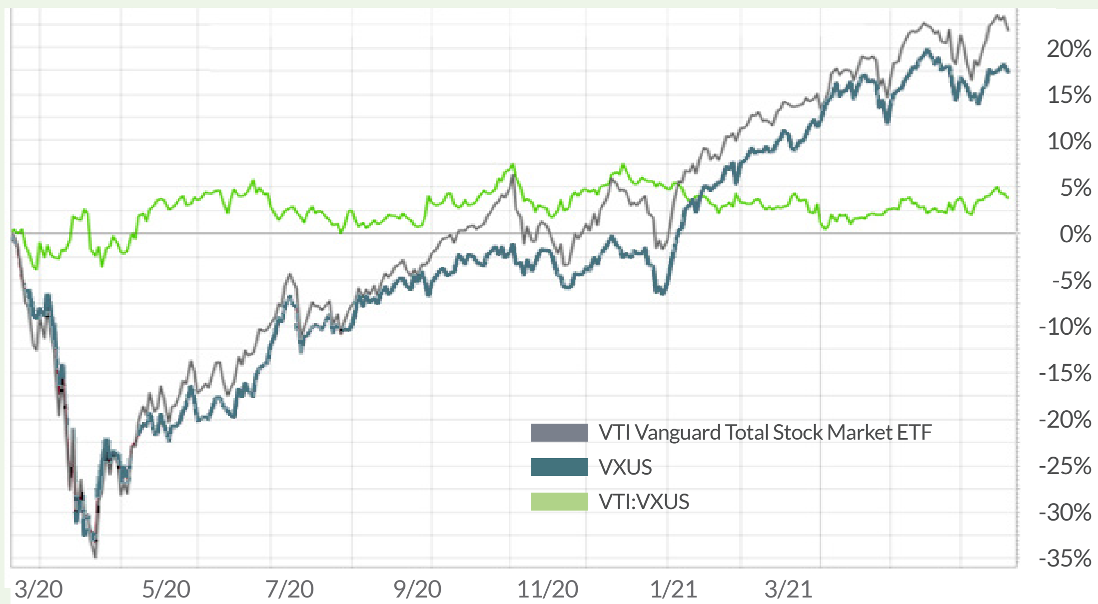

Figure 5 | US vs. Ex-US Stocks | One Year ended March 18, 2021[7]

Source: Stockcharts.com

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3 DIVERSIFICATION IS DEAD. LONG LIVE DIVERSIFICATION.

This is no time to abandon diversification. US large cap stocks are richly valued, and many forecasters say the S&P 500 will be the next big laggard (GMO & Vanguard, for example). Investors today need to evaluate the market more fully; volatility has ticked down from last spring and the markets have surged. Now is a good time for you to help your clients focus on risk management and defend and endorse diversification.

The Traditional 60/40 Portfolio is at High Risk

The bull market of 2009 through early 2020 rewarded concentrated large cap US stocks portfolios and even traditional 60/40 portfolios. The investing environment is very different today. The S&P 500 forward P/E ratio on March 31, 2021 was 21.9x according to JPMorgan. The subsequent 5-year annualized return with such a high starting forward P/E is expected to be fractionally negative (before inflation) according to JPM's research[8] as shown in Figure 6.

Meanwhile, interest rates crept higher from March of last year, then jumped quickly in Q1 2021. The result has been a more than 4% total return decline in the US aggregate bond market from the high in early August 2020 to mid-March 2021. Going forward, the US bond market is likely to deliver lackluster returns considering the aggregate bond index's yield to maturity is a paltry 1.4%.[9] Compare that very low yield to maturity to five-year break even inflation rates at 2.6%.[10] Bond market investors are almost certain to experience negative total real returns in the coming five years.

It's hard to imagine a 60/40 US stock/US bond portfolio providing impressive returns over the next five to 10 years given high US large cap valuations and exceptionally low current interest rates. Once again, the old way of thinking needs to be re-evaluated. Portfolios must be constructed with limited exposure to these overvalued pieces of the investment universe.

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WITH TODAY'S HIGH FORWARD P/E, THE SUBSEQUENT 5-YEAR ANNUALIZED RETURN IS EXPECTED TO BE FRACTIONALLY NEGATIVE BEFORE INFLATION

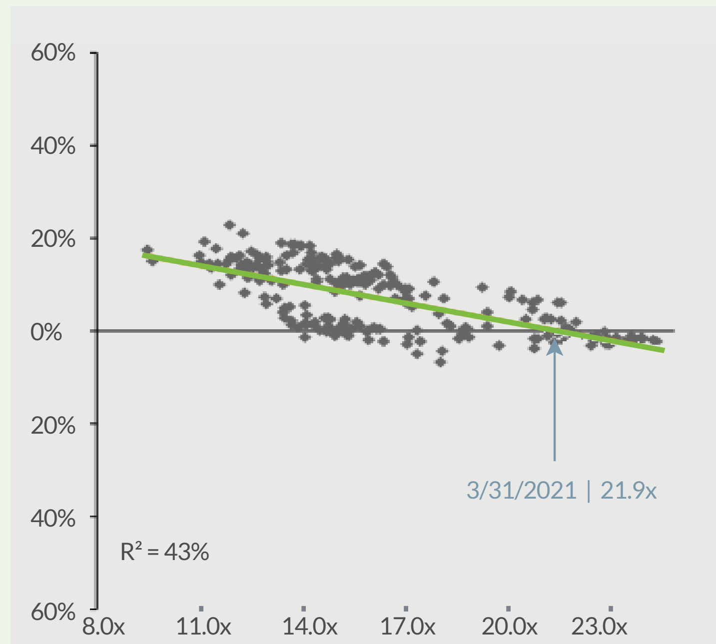

Figure 6 | S&P Total Return Index Forward Returns by Starting Forward P/E Ratio | 3/31/2021[8]

Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management

The good news is there are strategies at our disposal today that did not exist 15 years ago. These tools can help define risk and return outcomes. Real assets such as real estate, commodities, energy-related holdings, private equity investments, and absolute return fixed income are important strategies in this toolbox.

Diversify. Now more than ever.

It might be the toughest time in history to maintain a diversified portfolio. That's a dramatic statement, but consider today's culture and technology. It seems everybody has a trading app and a social media account. The "fear of missing out" makes sticking to a boring investment strategy, such as a well-diversified portfolio, feel like a losing proposition when we see countless tweets, Instagrams, and text messages from friends, family or even strangers making a killing in the latest cryptocurrency, meme stock, or high-flying tech company.

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Bad investor behavior is everywhere. Encouraging your clients to take a step back, breathe deeply, and embrace a long-term and realistic focus can lead to an optimal outcome. Good investor behavior and proper portfolio construction are far more significant in reaching financial objectives than saving a few basis points on fees as the driver for fund selection.

Conclusion

Retail investors, and even those in the advisory profession, are prone to recency bias. US large cap growth stocks beat nearly all major sub-asset classes since 2010. It's easy for clients to point to the investment with the best recent return and say, "I want that."

As advisors, we want to do the responsible thing for our clients: explain the benefits of diversification with evidenced-based probabilistic future returns.

Valuations are high now for US equities, which implies performance over the next decade will likely be disappointing. Positioning portfolios toward value stocks, some small caps, international equities, and private securities will likely bring better future risk-adjusted returns.

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Author Biography

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Daniel Wildermuth is the founder and CEO of multiple financial services firms. These include Wildermuth Advisory, LLC, an institutional fund advisor, Wildermuth Securities, a fund distribution brokerage firm, and Wildermuth Asset Management, a money management firm administering more than 20 equity, fixed income and alternative portfolio strategies for retail and institutional investors.

For 25 years, Daniel has been a pioneer in the adaption of the Endowment Investment approach to the needs of individual investors. He has been featured in Barron's, Investment News, Forbes Magazine, Family Office Magazine, CNBC, Bravo TV, Dow Jones Newswire, and other financial market news outlets. Daniel earned an MBA in Finance from Anderson School at UCLA and an undergraduate degree in engineering from Stanford University.

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Endnotes

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2 "PerfChart of FB,AAPL,AMZN,MSFT,GOOGL,IJS." StockCharts.com. Accessed 17 Mar 2021.

3 "Market Insights: Guide to the Markets® U.S. 2Q 2021 As of March 31, 2021." JPMorgan.com. Accessed 17 Mar 2021.

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5 "Market Insights: Guide to the Markets® U.S. 2Q 2021 As of March 31, 2021." JPMorgan.com. Accessed 17 Mar 2021.

6 Delaney, CFA, Jennifer. "Why it's time for U.S. Investors to Consider Overseas Stocks." iShares.com by Blackrock. 25 Aug 2020. Accessed 16 Mar 2021.

7 "PerfChart of VTI,VTI:VXUS,VXUS." StockCharts.com. Accessed 18 Mar 2021.

8 "Market Insights: Guide to the Markets® U.S. 2Q 2021 As of March 31, 2021." JPMorgan.com. Accessed 17 Mar 2021.

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10 "5-Year Breakeven Inflation Rate." FRED Economic Data. Fred.StLouisFed.org. Accessed 17 Mar 2021.

Definitions

Forward P/E Ratio estimates a company's likely earnings per share for the next 12 months. The forward P/E ratio is favored by analysts who believe that investment decisions are better made based on estimates of a company's future rather than past performance.

IShares S&P Small Cap 600 Value ETF seeks to track the investment results of an index composed of small-capitalization U.S. equities that exhibit value characteristics.

MSCI All Country World Index (ACWI) is a stock index designed to track broad global equity-market performance. Maintained by Morgan Stanley Capital International (MSCI), the index is comprised of the stocks of about 3,000 companies from 23 developed countries and 26 emerging markets.

S&P 500 Total Return Index is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S. and assumes reinvestment of dividends.

VTI is the Vanguard Total Stock Market ETF tracks the performance of the CRSP (Center for Research in Security Prices) U.S. Total Market Index, which is comprised of nearly 4,000 constituents across mega, large, small and micro capitalizations, representing nearly 100% of the U.S. investable equity market.

VTI:VXUS is the ratio of US stocks versus non-US stocks – when the ratio is increasing, US stocks are outperforming non-US stocks.

VXUS is the Vanguard Total International Stock ETF that tracks tracks the performance of global company stocks listed on the FTSE Global All Cap ex U.S. Index. The target benchmark index follows large-, mid-, and small-cap equities of companies operating outside the United States.

One cannot invest directly in an index.

Important Information

The Wildermuth Endowment Fund is a non-diversified, continuously offered closed-end fund that operates as an interval fund.

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