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MONTHLY UPDATE

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Chasing the Squirrel?

by

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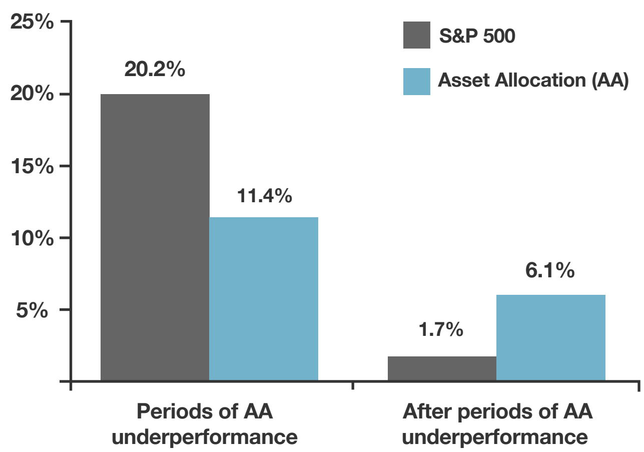
For those who have seen the movie "Up!" you will understand the reference to the call of "Squirrel!" For those who have not, it is an animated film that includes an energetic golden retriever that gets distracted from his train of thought every time he sees a squirrel. (After several years, my wife Lisa and I are finally getting re-acquainted with non-animated films and discovering animated movies are more uplifting – no pun intended!) In any event, we use this quote in our house when our son Axel (and he with me) gets distracted from whatever task is at hand. Chasing single asset class outperformance is the investor equivalent of chasing the Squirrel.

Just as asset classes cycle through periods of over and underperformance, so do investment indices compared to diversified portfolios. Of course a diversified portfolio will always underperform the highest performing of asset classes from the portfolio. However, the purpose of diversification is not to obtain outperformance in strong years, but minimize losses in down years. What follows is part of a recent weekly commentary from our friends at JP Morgan that supports this rationale.

The current bull market has not been kind to asset allocation, and following the post-election run in equity markets, some investors are wondering: is diversification still worth it? Frankly, this is a fair question to ask – as of February, the S&P 500 had outperformed an asset allocation portfolio by 54.7% on a cumulative five-year basis, a statistic that is sure to sting investors who might already feel that they have missed out on the full potential of this bull market. Importantly, this is not the first time that the broad equity market has outperformed a diversified portfolio, and it surely won't be the last. However, investors should not fall into the trap of chasing performance, and in this case, abandoning diversification in pursuit of greater returns from asset classes that have "worked." Instead, they should ask themselves another question: after periods of asset allocation underperformance, what happens next?

CHART OF THE WEEK

Asset allocation outperforms the index after weakness
Avg. ann. returns by 5-yr period, S&P 500 and AA portfolio



As the chart of the week shows, when the S&P 500 has outperformed a diversified portfolio over a trailing five-year period, the following five years typically result in an underperformance relative to the diversified portfolio of roughly 4.4% per year. This should help to assuage some concern and make a strong case for asset allocation: underperformance won't be persistent, and typically reverses itself to the diversified investor's benefit. As a result, if history is any guide, investors should remain patient, avoid emotional biases and stick to a plan. JP Morgan Weekly Market Update, March 27, 2017.

Enjoy the beginning of summer this month and remember to let your disciplined approach drive your investment policy – not the regret of a perceived missed opportunity demonstrated by a single asset class.

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