Modern Portfolio Theory……..It Still Works

The S&P 500 had another good year in 2016. However, almost every investor is asking themselves, and their advisors, "Why isn't my portfolio up like the market". Well, the answer to that question actually lies within the question itself. First of all, right or wrong, most investors are now defining the "Market" as simply large cap domestic stocks (S&P 500). Secondly, most investors and their advisors have assembled a portfolio, and this, by definition, is diversified among numerous asset classes, not focused solely on large cap domestic stocks.

Let's start by exploring the "Market". It's true that over the last 5 years, the S&P 500 has been on an incredible run, and has generated returns that have outpaced almost every other asset class. However, a diversified portfolio includes many other asset classes including international equites, mid-cap and small-cap equities, emerging market equities, corporate bonds and government bonds. The inclusion of these other asset classes are done not to deliver excess returns, but to blend various asset classes with different risk profiles to help bring the entire portfolio's overall deviation (commonly understood as volatility) down, without unduly sacrificing returns. "It is mathematically impossible to keep pace with an unrelenting run in U.S. stocks when you own anything other than U.S. stocks." Well put here by Charlie Biello at Pension Partners

We've attached a chart showing asset category returns for the last 10 years. While a well-diversified Pension Benchmark (60% blended equities and 40% fixed income) has underperformed the S&P 500, there is significant volatility reduction without sacrificing excessive returns. The reality is that almost every well-diversified portfolio has in fact underperformed an un-diversified U.S. equity portfolio for the last 5 years. Does this now mean that investors should ignore every aspect of Modern Portfolio Theory, as advanced by Harry Markowitz? Only if investors are certain that the last 5 years will be repeated, AND only if investors can stomach significantly more volatility, AND only if investors can handle much higher drawdowns (the S&P 500 lost 37% in 2008 and another 13% in the first 3 months of 2009).

The stark reality is that nobody knows for sure what will happen over the next five years, and very few investors can truly handle volatility/drawdowns that exceed their desired risk tolerance. Therefore, we diversify as protection for an unknown future as well as the inevitable emotional responses that commonly occur during periods of volatility and drawdowns. At Dashboard, we remain entirely accountable for overall investment performance, but we remain steadfastly resolute in the helping our clients achieve the

highest probability of reaching their own personal financial goals. This is most efficiently done by continuing to adhere to our established guidelines for diversified portfolio construction and vigilant ongoing monitoring.

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