MARKET OBSERVATIONS
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INVESTMENT COUNSEL

# Diversification

2022 was a challenging year for most markets, especially stock and bond markets. The total U.S. stock market declined more than -20%, the lowest return since 2008. The taxable U.S. bond market fell -13%, its lowest return in decades. The magnitude and concurrence of these losses has prompted a questioning of traditional portfolio diversification benefits. While certainly this diversification provided limited benefit last year, dismissing this investment principle on one year's outcome may be unwarranted. A review of diversification outcomes over time can provide perspective for investing in markets ahead.

## PERSPECTIVE

The pairings of stock market and bond market returns for rolling 12-month horizons are shown in Chart I. The 1,200 observations over the past 100 years provide meaningful data for analysis. Of note is the vast majority of positive returns (75% for stocks and 91% for bonds). Also of note is that the 2022 outcome was truly an outlier. Concurrent negative returns from both stocks and bonds has occurred in only 3% of all 12-month horizons. More often than not, diversification between stocks and bonds has been a benefit. In the 25% frequency of negative stock returns, bond returns were positive 88% of the time. Mitigating the 2022 outlier experience was possible by implementing tactical strategies within market sectors, e.g., shortening bond duration and increasing stock quality.

In discussions of portfolio diversification, the usual default reference is to the 60/40 portfolio, i.e., 60% stocks and 40% bonds. Chart II shows the 60/40 portfolio return for rolling 12-month horizons over the past 100 years. The average return for the full period was +9.6%. 80% of the time, the portfolio return was positive. This was an improvement on the 75% positive frequency for stocks alone. The positive/negative return frequencies suggest a negative return once every fifth year. The actual occurrence was much different. There tended to be longer time gaps between negative outcomes, and then such outcomes were bunched together.

Another investment principle is that higher portfolio returns come with taking higher levels of risk. The historical return/risk tradeoffs from portfolios diversified between stocks and bonds in Chart III shows this reality. Over the past 100 years, average portfolio return has increased along with increases in the allocation to stocks. Risk, expressed as the variability of returns around the averages, increased as well. This can be seen in the widening of the area between the higher and lower bands as the stock allocation rises. This area captures about two-thirds of all outcomes. The 2022 60/40 portfolio return of -17.3% was literally off this chart.

## INVESTMENT IMPLICATIONS

While broad portfolio diversification was a limited benefit last year, it has been a value-added investment principle over time. So too has been the benefit of implementing tactical portfolio strategies. While taking more risk can lead to achieving more return, the determination of the appropriate risk level turns on a more complete understanding of individual circumstances. Specific goals, time horizons and risk tolerances will suggest an appropriate level of risk to be taken. Taking a higher level of risk may reduce the odds of achieving specific goals.

CHART I

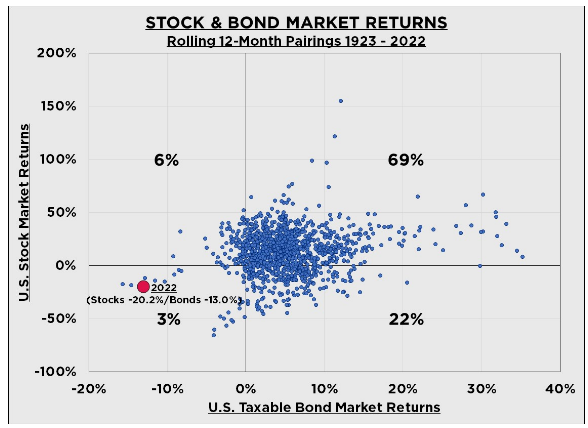


CHART II

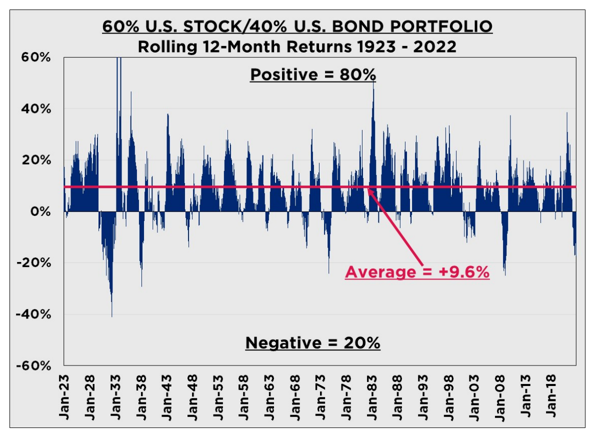


CHART III