The Art of Patient Investing

RESEARCH | OCTOBER 2024

Financial news headlines have been dominated recently by tech stocks. The performance contributions of the so-called Magnificent Seven, references to an increasingly tech-heavy S&P 500 Index, and the rising concern regarding Nvidia's rapid ascent to becoming one of the most valuable companies in the world, may be prompting investors to question the benefits of a diversified portfolio. Is it still relevant in today's market environment?

The Question of Diversification

Historically, diversification has proven to be a crucial strategy in investing by improving the risk-return tradeoff, smoothing out market fluctuations, and providing investors with greater certainty about the range of potential returns.

In recent years, however, large-cap US stocks have dramatically outperformed most asset classes. Almost every other asset class outside of large-cap US stocks in a diversified portfolio has served as a drag on portfolio returns (see Figure 1). This trend may be testing many investors' patience with diversification. Investors may question whether it still makes sense to focus on building well-diversified portfolios.

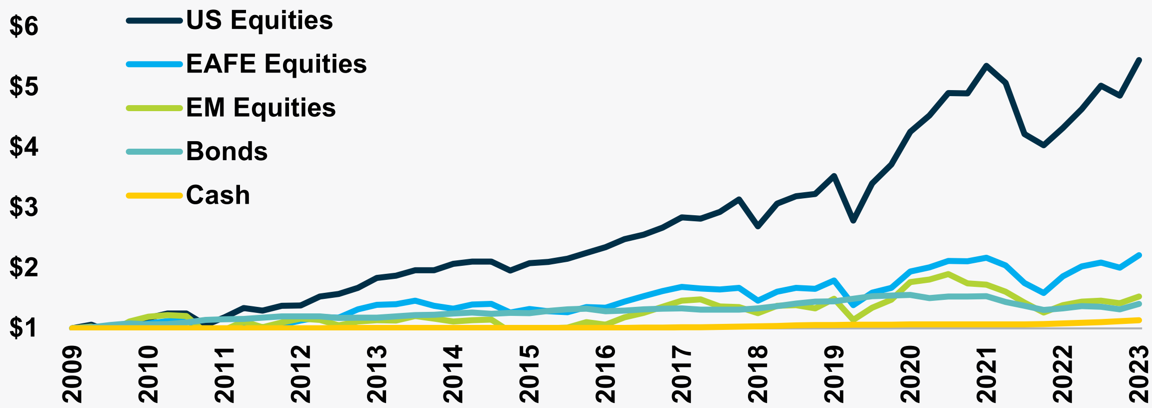

FIGURE 1

Growth of $1 Invested in Public Markets Since 2010

Represents the period from January 2010 through December 2023. Benchmarks used are as follows: Russell 3000 for US Equities, MSCI EAFE for EAFE Equities, MSCI EM for EM Equities, Bloomberg US Aggregate for Bonds, and Bloomberg 1-3 Month US T-Bills for cash.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

The Benefits of Diversification

Diversification is often considered the only “free lunch” in investing. Diversification allows an investor to build a portfolio with a potentially better expected risk-return tradeoff. The right combination of asset classes may smooth out the extreme fluctuations in markets without sacrificing potential returns. This is because different asset classes do not always move in sync with each other.

An undiversified portfolio often represents a bet, intentional or not, on specific market conditions. Predicting the direction of the markets with any consistency is particularly challenging. Even though investors may feel confident that they know the direction the markets will take in the near term, unexpected events often occur. For example, major events such as wars, pandemics, and financial crises have a history of quickly changing the prevailing economic environment. This argues for designing a portfolio to weather differing scenarios rather than betting on a portfolio designed to benefit from the current environment, even if an investor believes it is likely to persist.

By diversifying, an investor can construct a portfolio with similar risk but a higher expected target return. Alternatively, they could design a portfolio for lower risk without sacrificing expected return. This is because adding asset classes that are not correlated with the primary assets in a portfolio may decrease overall risk. This can even be true for assets that are riskier on a standalone basis, especially if they tend to be negatively correlated with the rest of the portfolio.

Each Asset Class Should Play a Specific Role

It may help an investor to consider their portfolio in a similar way to how they look at their favorite sports team. For example, a successful baseball team cannot just have nine players in the shortstop position on the field. Rather, they need a team where each position plays a different and vital role. The same concept applies to portfolios – different asset classes should work together like a well-rounded team. And like players on a baseball team, some assets may have periods of “slumps” or “hot streaks”. Having a diverse team of different asset classes makes it possible for other assets to “pick up the slack” during slumps so that the overall portfolio is more protected from the volatile swings of slumps and hot streaks.

Diversification Can Potentially Smooth Out the Dips

Diversification can potentially increase the likelihood of having some exposure to the best-performing asset classes. It likewise may prevent investors from having excessive exposure to the worst asset classes. This may even include diversifying among asset classes that are considered risky (e.g., public and private equities). For example, between 1999 and 2010, average annualized returns were 2.8% for US stocks, 14.7% for emerging market stocks, and 13.0% for private equity.[1] Reliance on US equities alone during this period would likely have left many investors short of their objectives.

[1] Source: Data from Investment Metrics. Represents average annualized returns. Indices used are Russell 3000 index, MSCI Emerging Markets index, and CA Private Equity composite via IHS Markets.

A broadly diversified portfolio is likely to smooth out the worst downturns. A portfolio dominated by stocks would have suffered much worse than a diversified portfolio during the Global Financial Crisis ("GFC") or the popping of the dot-com bubble (see Figure 2). Having investments in assets that performed well during these periods, such as high-quality bonds, not only mitigated these losses but also provided a liquid source of assets that investors could use to rebalance into assets that had become substantially cheaper (e.g., equities).

Markets during the Global Financial Crisis and the popping of the dot-com bubble

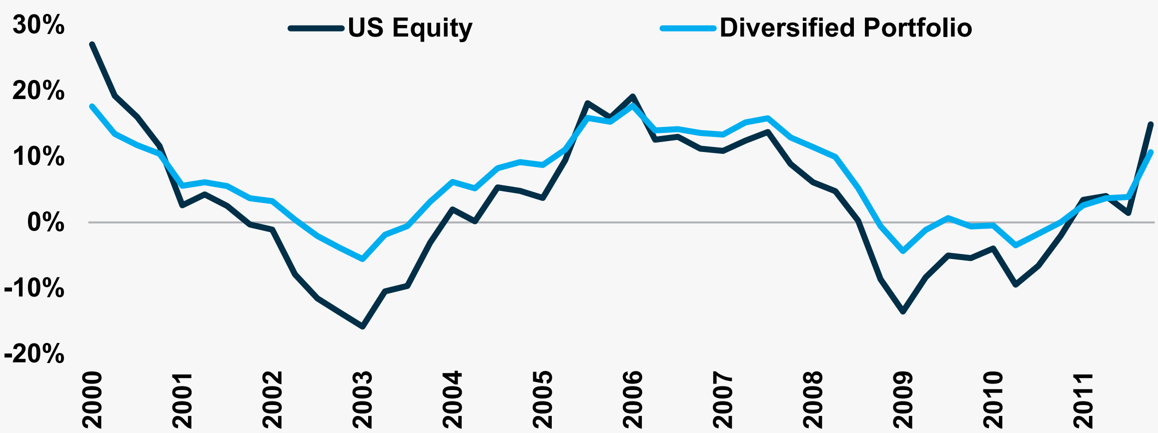

FIGURE 2

Rolling 3-Year Returns

Data Source: Investment Metrics. The period shown is from 2000 through 2011. US Equity is proxied by the Russell 3000. The diversified portfolio is proxied by 30% Russell 3000, 15% MSCI EAFE, 5% MSCI EM, 10% CA Private Equity, 10% NCREIF ODCE Equal-Weighted, and 30% Bloomberg Aggregate.

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It's Easy to Forget Time Frames Matter

Historical returns may present a biased or incomplete picture, depending on the period chosen, particularly when they represent a single "snapshot" of time. Such "endpoint bias" refers to the inclusion or exclusion of data that significantly skews results. That is, if the recent past (or the starting period) witnessed unusually high or low returns, then long-term results can change considerably. Often, this results from typical market cyclicality.

Relying solely on data that is biased in this fashion can result in investors making flawed decisions. The last decade is replete with trends that are affecting long-term data, and hence they may skew the way investors' decisions are framed. It can be too easy for investors to give up on certain asset classes and load up on the asset class that has been in favor recently. Doing so has been costly historically when trends change. Being cognizant of endpoint bias can help investors make more informed (and hopefully better) decisions.

An Example of Endpoint Bias

Value and growth stocks tend to move in cycles of relative outperformance. For example, as of March 2000, the Russell 1000 Growth Index outperformed its Value counterpart over all trailing periods, fueled by impressive recent performance (see Figure 3).

Example of how an historical event (bursting of the dot-com bubble) can reverse the performance leadership of growth and value stocks

FIGURE 3
Annualized Returns as of March 2000

Source: Data is from Bloomberg. Inception for both Russell 1000 Growth and Russell 1000 Value indices was January 1979.

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As of 03/31/2000	1 YR (%)	5 YR (%)	10 YR (%)	20 YR (%)	Since Inception (%)
Russell 1000 Growth	34.1	31.8	21.6	18.5	18.3
Russell 1000 Value	6.3	21.0	16.0	17.2	16.8

From this data, investors might have concluded that growth stocks offer a long-term premium relative to value stocks. However, just one year later with the bursting of the dot-com bubble, the premium had reversed over all historical periods (see Figure 4).

FIGURE 4
Annualized Returns as of March 2001

Source: Ibid.

Note: Past Performance is Not Indicative of Future Performance. May Lose Value.

As of 03/31/2001	1 YR (%)	5 YR (%)	10 YR (%)	20 YR (%)	Since Inception (%)
Russell 1000 Growth	-42.7	11.6	12.7	13.2	14.5
Russell 1000 Value	0.3	14.2	15.2	15.3	16.0

Behavioral Bias and Performance Chasing

Many investors suffer from behavioral biases that may result in performance-chasing behavior. They may be fearful when the market declines and hence get more conservative at an inopportune time. Conversely, they may also chase good returns by investing in risky assets after a period of strong investment gains. Succumbing to these mistakes may lead to poor decisions, and hence poor portfolio outcomes. This is partly because return-chasing behavior often leads to buying high and selling low.

Evidence shows that investors' performance lags the actual performance of the funds/markets in which they invest (see Figure 5). Specifically, the time-weighted average return for a fund tends to be higher than the dollar-weighted return. This implies that investors have piled money into funds after those funds have achieved their best performance and that investors have tended to leave their money in those funds after performance fell below average.

US Category Group	Investor Return (%)	Total Return (%)	Performance Gap
US Equity	10.99	11.77	-0.79
International Equity	3.30	4.89	-1.59
Sector Equity	6.42	10.80	-4.38
Taxable Bond	0.20	1.57	-1.36
Allocation	5.98	6.44	-0.46
Overall	6.04	7.71	-1.68

FIGURE 5

The Performance Gap by Asset Class (10-Year Returns)

Source: Morningstar, "Mind the Gap 2022." https://www.morningstar.com/funds/bad-timing-cost-investors-one-fifth-their-funds-returns. Morningstar updates the study annually, with roughly similar results each year, showing that the returns that investors experience is below the returns that the funds produce because of the manner in which investors tend to move in and out of funds in each category.

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The Value of Patience

In general, investors should typically be patient with underperforming asset classes because market cycles can cause fluctuations in performance, and asset classes that are currently underperforming often rebound over time. Patience usually allows investors to ride out the volatility and potentially benefit from the long-term growth that these asset classes may offer.

Additionally, having a long-term perspective is typically beneficial. Investors may profit by suppressing the urge to always "do something." Often the best course of action is to take no short-term action at all, especially if they are inclined to chase performance or over-react to recent events. If an investor truly has a long-term horizon, they are generally best served by acting as a long-term investor.

Having discussions about and setting appropriate expectations around market cycles is an important aspect of effectively managing the situation if underperformance happens. This might include scenario analysis and stress testing, as well as looking at performance with an eye toward endpoint bias. This preparation for, and understanding of, risk can contribute to the patience needed to stay the course with underperforming asset classes.

Diversification Still Delivers Value

Diversification is an important component of investing. A well-diversified portfolio may improve expected risk-return tradeoffs and is less reliant on specific market conditions. Market cycles can cause dramatic fluctuations in performance. The duration of such cycles can be painfully long. Yet such extended periods of out- and underperformance are normal in most markets.

Investors should be mindful of endpoint bias and behavioral biases. Investors tend to place undue significance on recent events and extrapolate the recent past into the future. By being aware of such biases, investors may minimize the likelihood of making potentially flawed investment decisions. This includes selling underperforming assets at the wrong time.

Distinguishing between secular changes and cyclical trends is challenging at best. Investors who develop a long-term plan and stick with it may be able to avoid the worst outcomes. The combination of patience and diversification will likely help investors avoid being adversely affected by shifts in market leadership.

Glossary of Indices

S&P 500 Index | tracks the stock performance of 500 of the largest companies listed on stock exchanges in the United States.

Russell 3000 Index | is a capitalization-weighted stock market index that seeks to be a benchmark of the entire US stock market.

Russell 1000 Growth Index | measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years).

Russell 1000 Value Index | measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years).

MSCI EAFE Index | measures the performance of large- and mid-cap companies across 21 developed markets countries around the world. Canada and the USA are not included. EAFE is an acronym that stands for Europe, Australasia, and the Far East.

MSCI Emerging Markets Index | captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,328 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Bloomberg US Aggregate Index | is a broad-based flagship benchmark that measures the investment grade, US dollardenominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency).

Bloomberg 1-3 Month US T-Bills Index | measures the performance of the public obligations of the U.S. Treasury with a maturity of between one and up to (but not including) three months.

Cambridge Associates LLC US Private Equity Composite Index | is a horizon calculation based on data compiled from 1,468 US private equity funds (buyout, growth equity, private equity energy and subordinated capital funds), including fully liquidated partnerships, formed between 1986 and 2017. Pooled horizon return, net of fees, expenses, and carried interest.

NCREIF ODCE (Open-End Diversified Core Equity) Equal-Weighted Index | is a fund-level capitalization weighted, time-weighted return index and includes property investments at ownership share, cash balances and leverage (i.e., returns reflect the fund's actual asset ownership positions and financing strategy).

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