Why Your Portfolio Shouldn't Match the Market

Kate Warne, Ph.D., CFA • Investment Strategist

If you own a better-diversified portfolio rather than just U.S. stocks, your portfolio likely hasn't kept up with the stock market recently. But it's typically less risky too, and historically, that diversification has increased the chances of positive returns.[1]

Well-diversified portfolios aren't designed to outperform the S&P 500. They're intended to be less risky, and they tend to perform better when stocks drop, since bond prices frequently move in the opposite direction from stocks.

When large-cap U.S. stocks rise more than most other asset classes, like they have in recent years, the performance of better-diversified portfolios often lags. This year, trade uncertainty and a rising U.S. dollar reduced returns on international investments. Keep in mind that markets don't tend to move together, and performance can change quickly. Make sure your portfolio stays aligned with your long-term goals and comfort with volatility.

Why Diversification Makes a Difference

Owning a variety of investments (called diversification) is designed to help reduce the volatility of your portfolio over time. A diversified portfolio typically isn't as risky and doesn't move as much as the stock market. So it's easier to appreciate this effect when stocks drop, since diversified portfolios typically decline less. But when stocks rise, diversified portfolios can lag.

No one wants to feel left behind, but that doesn't mean you should try to chase better-performing stocks or certain stock sectors. You own a diversified portfolio because you don't want to take that much risk.

Bonds and stocks typically move in opposite directions

Your mix of stocks and bonds is one of the most important investment decisions you make, and that mix has no doubt played a key role in determining the short-term performance of your portfolio. Stocks and bonds frequently move in opposite directions, helping stabilize balanced portfolios during bouts of volatility. This year, as major central banks eased policy and rates fell, both bond and stock prices rose, with stocks outperforming.

Stock prices have continued to rise, yet more slowly

U.S. economic and earnings growth moderated in 2019 as the effect of tax cuts has faded and trade tensions have risen. Although the pace of growth is likely to slow further in 2020, we believe steady corporate fundamentals, a healthy labor market and fresh stimulus from the Federal Reserve will support rising stock prices over time.

U.S. interest rates have dropped

The Federal Reserve cut rates for the first time in a decade to sustain the economic expansion amid softness in business investment and below-target inflation. Low inflation, increased foreign demand for U.S. Treasury bonds and an aging population are likely to keep rates at relatively low levels for longer. However, if global growth improves, long-term interest rates could rise modestly.

International prospects likely to improve

International equities underperformed in 2019 as trade tensions escalated, manufacturing activity contracted and the U.S. dollar rose. Trade and other geopolitical uncertainties, including Brexit and U.S. elections, are likely to keep volatility elevated, but we expect growth to stabilize and returns to improve. Headwinds remain, but we believe any de-escalation in trade tensions or a weaker dollar could be catalysts for a rebound in international equities. In addition, international equities have more attractive valuations as well as support from low interest rates and global monetary stimulus.

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Keeping Time on Your Side

While it may be hard to stay patient when your portfolio lags, it's important to remember that one of the most powerful drivers of long-term returns is time invested. Staying invested keeps time on your side. The table below shows the chances of positive returns.

- Staying invested over longer periods of time increased investors' chances of earning positive returns. That's true for stocks, a mix of U.S. stocks and bonds, and a better-diversified portfolio that includes international stocks. The percentages rise as time increases.
- Adding fixed income increased the chances of earning positive returns across all time periods compared to owning just stocks.
- The better-diversified portfolio that includes a combination of U.S. and international stocks as well as fixed income had the highest chance of positive returns over all time periods.

The last column shows the positive impact international stocks can have on your portfolio. That's why we think keeping time on your side and owning international investments is important.

What Are the Chances of Positive Returns?

More Diversified Portfolios Had Higher Chances of Positive Returns

Time Horizon	S&P 500	65% U.S. Stocks / 35% Bonds	65% U.S. & International Stocks / 35% Bonds
1 Month	64.4%	65.5%	66.1%
1 Year	81.5%	84.1%	86.2%
3 Years	88.0%	89.7%	89.9%
5 Years	89.5%	99.1%	99.1%
10 Years	93.7%	99.5%	99.7%

Figures represent the percentage of time the portfolio increased. Source: Morningstar Direct, 1/1/1976–9/30/2019. The hypothetical portfolios consist of 100% stocks represented by the S&P 500 Total Return Index; 65% stocks represented by the S&P 500 Total Return Index and 35% bonds represented by the Barclays U.S. Aggregate Bond Index; and 48.75% U.S. stocks represented by the S&P 500 Total Return Index, 16.25% international stocks represented by the MSCI EAFE NR Index and 35% bonds represented by the Barclays U.S. Aggregate Bond Index, respectively. The hypothetical portfolios are for illustrative purposes only. Results may vary for an individual portfolio with similar holdings. Indexes are unmanaged and are not available for direct investment. Past performance of the markets is not a guarantee of how they will perform in the future. Investing in stocks involves risk. The value of your shares will fluctuate, and you may lose principal. The prices of bonds can fluctuate, and an investor may lose principal value if the investment is sold prior to maturity.

1 Source: Morningstar Direct,1/1/1976–9/30/2019. Past performance of the markets is not a guarantee of how they will perform in the future.

Diversification does not guarantee a profit or protect against loss in a declining market. Past performance is not a guarantee of future results.

Investing in equities involves risks. The value of your shares will fluctuate, and you may lose principal. Small- and mid-cap stocks tend to be more volatile than large company stocks. Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events. Before investing in bonds, you should understand the risks involved, including credit risk, market risk and interest rate risk.

Considering Changes?

If your portfolio is well-diversified, at any given time you are likely to own an investment with disappointing performance. But don't switch or sell it now – historically, performance rotates, and the laggards can turn into leaders over time. Consider the following instead:

- Make sure you own the mix of stocks and bonds that's appropriate for your comfort with risk and your long-term financial goals, so you're comfortable during more volatile markets.
- Consider improving your portfolio's diversification by adding more asset classes, since they perform differently from one another over time and play different roles in your portfolio.
- Remember that when stocks dropped by more than 15% in late 2018, bonds increased modestly. We expect bonds will continue to play an important role in stabilizing portfolios.

More Volatility Ahead?

Economic policy uncertainty has been high, and you'll probably hear many reasons to worry about the short-term future. But don't let that list of worries stop you from investing in an appropriate mix of stocks and bonds. Prepared investors can stay invested throughout.

