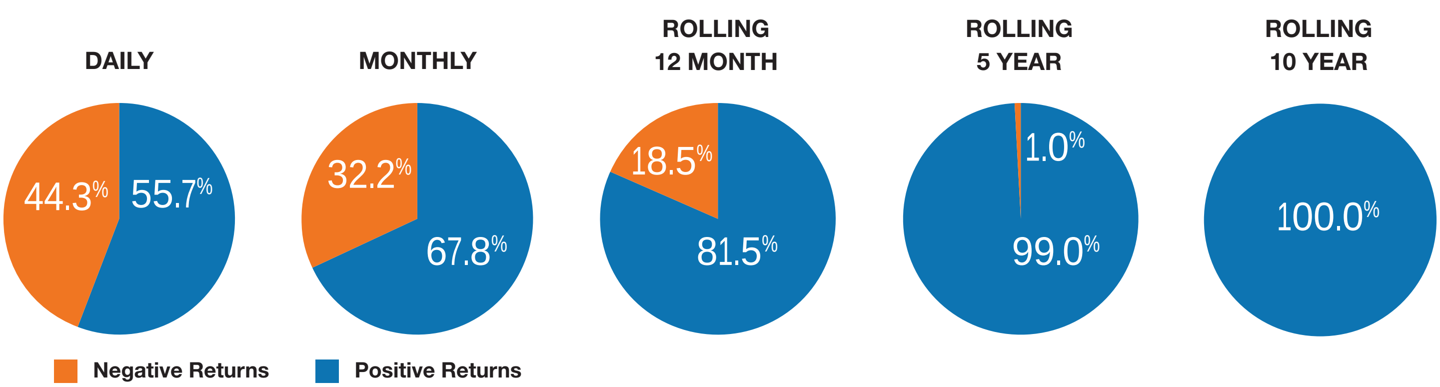
Is it Time to Get DEFENSIVE?

Offense wins games, but defense wins championships. More than ten years into one of the longest bull markets on record, it is natural human behavior to think maybe this is as good as it gets. With the 24/7 news cycle, investors are bombarded with news and perspectives that threaten the end of a historic run. But before making any decisions, it is helpful to consider the probability that a diversified portfolio prevails with a positive return. As it turns out, we believe your diversified portfolio may be a dynasty for the ages.

You Are the Favorite

The 1920s New York Yankees led by Babe Ruth and Lou Gehrig were known as Murderer's Row. In the 1990s, Michael Jordan and Scottie Pippen elevated the Chicago Bulls to the all-time dynasty discussion with six championships. And even more recently, Bill Belichick and Tom Brady have been racking up championships with the New England Patriots for almost two decades. Each of these behemoths dominated their sport, but despite being favored to win almost every game, they did not win every single game. In the same light, a diversified portfolio will not generate a positive return every day. But we believe evidence shows that the longer you stick with the favorite, the higher the likelihood of achieving success.

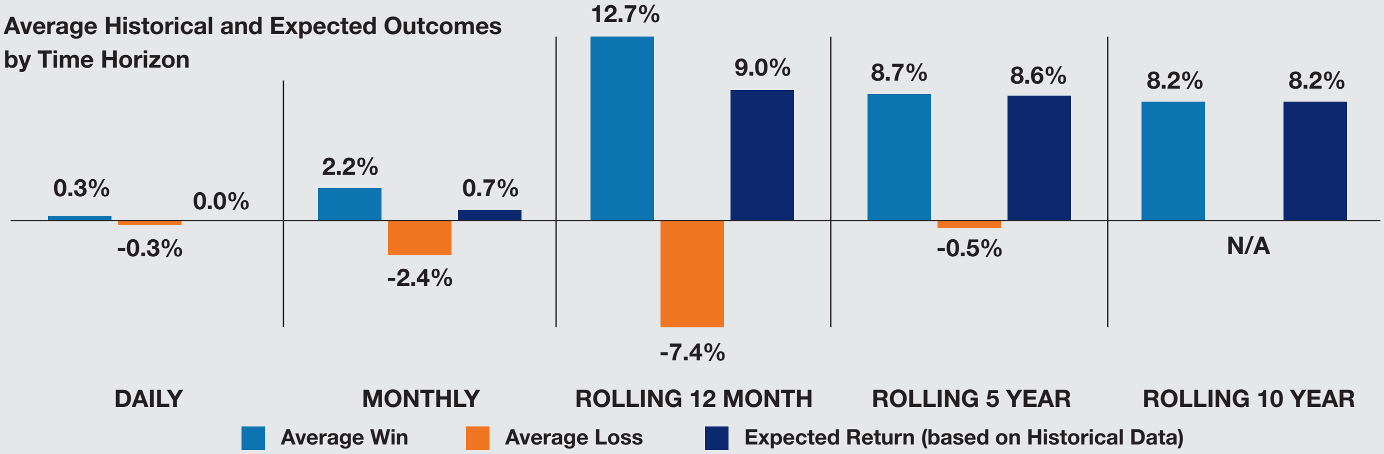
Percentage of Positive/Negative Returns for Varying Time Periods for a Hypothetical Diversified Index Portfolio



Using data back to 1989, we can examine the probability that a diversified index portfolio composed of 65% stocks, 22% bonds, and 13% alternatives wins (goes up) or loses (goes down) over several time horizons. As it turns out, based on the empirical evidence, we think diversified investors should expect to win on any given day. And similar to some of sports' greatest dynasties, the longer you let the favorite play the game, the higher the chance for success.

A Dynasty Built for the Long Run

If a team wins every game but only by one point, fanatics may question if the team is truly great or just lucky – perhaps that is not sustainable next season. Using the same data, we can take a deeper look into the diversification dynasty to determine if it "wins" often enough, and by a high enough margin, to compensate for its losses.



**Expected Return is a function of the percentage of time a return is positive times the magnitude of the positive return plus the percentage of time a return is negative times the magnitude of the negative return. Example: Rolling 12 Month Expected Return = ((81.5% x 12.7%) + (18.5% x -7.4%)) = 9.0%*

On a daily basis, it turns out the average loss is very slightly larger than the average gain. Nevertheless, thanks to the higher probability of winning, fans of the diversification dynasty should still expect a positive, albeit very small, daily return of 0.03%. In any given month, losses again, on average, were greater than the gains, which can add stress for investors who focus on the short-term. Again, by winning more often than not, we should still expect a positive return in any given month. Furthermore, the longer your time horizon, the better the ratio of average win to average loss – creating strong long-term returns.

Does the Current Scenario Change the Odds?

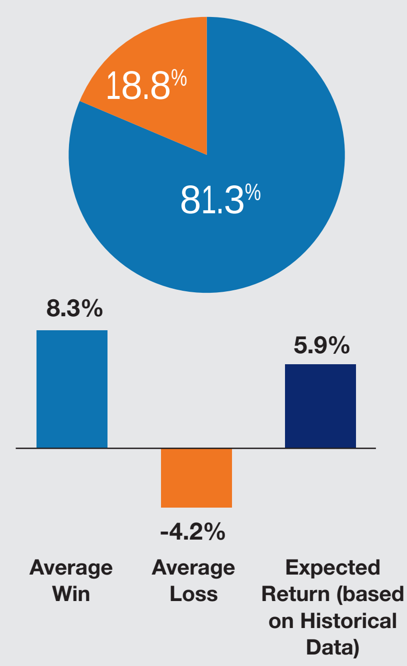
The market is more or less a random walk. This means that when the game ends one night, all players are fully rested and ready to perform the next night. Of course, some players may be fatigued and others injured. Currently, stock valuations are elevated and, depending upon your measure of choice, the yield curve is inverted or close to it. Within the same dataset, let's isolate periods when stock valuations were high and the yield curve was at least close to inversion. We will call stocks expensive when the Shiller CAPE ratio was above the 75th percentile within this dataset (or the 25% of the time stocks were most expensive) and say the yield curve is almost inverted (or inverted) if the yield of the 10 Year Treasury minus the 2 Year Treasury is 0.25% or less.

As it turns out, the pure probability of the diversified benchmark making money versus losing money is almost the exact same as our general dataset that did not condition for pricy stock valuations or a potentially inverted yield curve. But something has to give – and that is the payouts. The average loss is not quite as bad but the average win has also fallen enough to decrease the expected return from 9.0% to 5.9%.

As a diversified investor, some of your game days will go exactly as planned, just like when Jordan and Pippen led the Bulls to a blowout win. Other days, and less frequently according to the empirical evidence, the buzzer will mark the end of the trading day with a loss. With the evidence as our guide, rather than trying to guess which team will win, for long-term investors we believe it is best to stick with the dynasty – a diversified portfolio.

The diversified index portfolio referred to in this piece was allocated as follows: 16.6% CRSP US Total Market Index, 14.7% MSCI US Prime Market Value Index, 3.5% MSCI US Small Cap 1750 Index, 5.9% MSCI US Small Cap Value Index, 4.1% MSCI EAFE Index, 5.2% MSCI EAFE Value Index, 4.6% S&P EPAC Small Index, 4.6% S&P EPAC Small Value Index, 5.9% MSCI Emerging Markets Index, 6.6% IA SBBI US 1 Yr Trsy Const Mat Index, 7.7% BBgBarc US Govt/Credit Interm Index, 1.1%BBgBarc U.S. Treasury TIPS 1-5Y Index, 1.1% ICE BofAML US Infln-Lnkd Trsy Index, 5.5% JPM GBI Global Ex-US Hgd Index, 2.6% S&P Global REIT Index, 2.6% Bloomberg Commodity Index, 3.5% Credit Suisse Mgd Fut Liquid Index, 4.3% SwissRe Global Cat Bond Index. Some indices were appended with like indices prior to their inception date. Shiller CAPE ratio is the Cyclically Adjusted P/E ratio which is a valuation measure smoothed over a 10-year period. Data from Robert Shiller website (econ.yale.edu/~shiller/data.htm).

Historical Conditions Similar to Today: Stocks Expensive & Yield Curve Near Inversion



Note: This chart reflects 32 different 12 month rolling periods since January 1989 in which the CAPE ratio was above 27.55 and the ten-year minus two-year spread was below 0.25%.

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