Client's Corner

Why You're Not Getting the Return of the S&P 500

THERE COMES A MOMENT IN THE DEVELOPMENT OF ANY investment fad when broad swaths of the investing public begin asking, "Why in the world do we own anything other than (fill in the blank)?" The blank is interchangeably filled with the one asset class, market segment, industry group, individual stock or mutual fund/ETF whose stellar performance is making all the other choices seem like boring savings accounts.

Already in this century, one has heard this plaintive cry about (working backwards in time) the so-called Magnificent Seven tech stocks, Bitcoin, the funds/ETFs of the investment manager Ark Invest, pre-development condominiums in Scottsdale, and internet stocks such as AOL—this is not a misprint—and Cisco Systems. Just to name a few.

I take this issue up at this particular moment because once again I'm hearing this vexed inquiry, and on every side. Indeed I think it not beyond the realm of possibility that you yourself may have formulated this question in your mind—perhaps even going so far as to voice it to your financial planner/wealth manager. And felt quite reasonable in doing so.

Because the object of the investing public's fascination/affection this time around is not some wild-eyed speculation—far from it. It is that index of the stock prices of five hundred of America's leading companies: the Standard & Poor's 500-Stock Index. As in, "Why in the world do we own anything other than the S&P 500?"

In the context of these little essays, I seek to serve as an interpreter of, and advocate for, your financial advisor, ***as well as an investor just like yourself.*** As such, I take up the question in the form you may be asking it. To wit: why has your advisor not been getting you the full return of the S&P 500 these last several years? And the corollary question: why does he/she resist your seemingly well-founded impulse to get rid of the all-too-obvious laggards in your portfolio, and reinvest the proceeds in the blazing S&P 500?

The answer to the first question is almost certainly that your advisor has had you far more broadly diversified than just the Index ***out of concern for your risk tolerance.*** Broad diversification is, first and foremost, a risk-management device. And your advisor will have told you that by diversifying away from mainstream equities—into small-cap and international/emerging markets, to cite two obvious examples—you would historically be able to mute the volatility of your overall portfolio ***in both directions*** while ultimately capturing the historically superior long-term returns of those other sectors.

What that classically conservative approach to long-term equity investing has been doing these last several years is ***muting the upside,*** in that U.S. large company equities have been shooting out every light in the joint while the diversifiers lay dormant. Let me spell that out even more simply: ***your portfolio is doing pretty much exactly what it was engineered to do.*** In time, if history is any guide—and it's the only guide we have—sectors like small-cap and/or international will have their moments in the sun while big-cap U.S. (and especially big-cap growth) fades, if only relatively.

That it is taking a mighty long time for that role reversal to eventuate does not invalidate this strategy in the least, particularly in the mind of an advisor focused on guiding you toward (and through) a multi-decade retirement. These days, he/she may be daily reciting Buffett's dictum: "The stock market is a device for transferring money from the impatient to the patient."

The corollary question we proposed to examine asks why, in the face of years of overperformance by the S&P 500, your advisor doesn't see the wisdom of jettisoning the laggards and increasing your Index exposure. The answer here, I'm delighted to report, is simply that he/she is that rarest of creatures, a genuinely rational investor. And one of the bedrock fundamentals of financial rationality is that you don't liquidate sound out-of-favor (and thus potentially undervalued) investments to chase hugely popular (and thus potentially overvalued) sectors that have already had an epic run. ***If anything, quite the contrary.***

There are myriad statistical demonstrations of these historically incontrovertible conclusions, if the plain common sense above doesn't carry the day. Expect to find your advisor heavily armed with them should the need arise. I'll leave you with just one more thought.

On two separate occasions during a ten-year period in this century, the S&P 500 declined peak-to-trough on a closing basis 49% and 57%, respectively. It went down by a third in a single month when COVID hit. And barely two years ago at this time, the Index was in the process of crashing 25% in 10 months. Are you absolutely sure you want to concentrate most or all of your invested net worth in that?

For what little it may be worth: I sure don't. And I'm about as deeply committed a long-term equity investor as you're ever likely to meet. But I'm not trying to "outperform" anyone else. If anything, I'm trying to out-compound them in the long run.

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Sources: Standard & Poor's, Yahoo Finance