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Stay the course on investment strategy, even in a narrow market

VIEWPOINT
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Here's today's dirty little secret that no one wants to talk about: your investment portfolio is likely underperforming the market this year. Worse, you are probably lagging behind school-aged day traders on the new Robinhood trading app.

Why is that? Mostly because today's stock market is very narrow. Just a handful of stocks, including Google, Apple, Facebook, Microsoft, Amazon, Netflix, and Tesla, are driving the vast majority of the gains in the overall stock market. In fact, the top five stocks now account for over 20% of the value of the entire S&P 500, a record that even eclipses the Tech Boom of the 1990s. Unless you are invested in these stocks, and only these stocks, you are lagging behind.

Through the end of August, the top ten stocks in the S&P 500 earned returns topping 20% year-to-date, but the rest of the market declined in value by around 3%. Even with the market at all-time highs, 77% of the stocks that make up the broad Russell 3000 index are trading 10% or more below their 52-week highs.

What's an investor to do? Maybe sell everything and jump on the tech stock bandwagon? That certainly could prove lucrative in the short run, but it likely will result in heartache over time. Periods like the one we're in now come and go. The closest analog is the 1990s when technology stocks famously dominated the market and generated eye-popping returns for many years. Unfortunately, the subsequent market decline in the early 2000s was jaw-dropping for its severity and the toll it took on what were previously the most attractive stocks.

Large-cap growth stocks, mostly driven by the technology sector, earned an annualized return of 20% during the decade of the 1990s, but they lost an annualized 4% during the following decade. The tech-heavy Nasdaq Composite Index fell 78% from its March 2000 high to its low in October of 2002. Today's market may not be that extreme, but there are certainly signs that today's most in vogue stocks are trading at lofty levels and may be due for a correction.

Rather than chasing the performance of today's highfliers, diversification is still your best bet for long-term investing success. Cue the eye rolling. It is certainly true that diversification has become a quaint idea of an investment strategy. One that worked in the past but that now seems hopelessly outdated. However, market cycles come and go, and what is hot today will almost certainly look hopeless when the current cycle gives way to the next.

The hardest part of all this is that these cycles are unpredictable and can continue for many years. A lot of investors think of 3-5 years as "the long-term." However, 3-5 years is really just statistical noise in the world of the capital markets. Cycles that appear unsustainable can continue for ten years or more. This lulls us into believing that something has permanently changed, and that we need to adopt new approaches to investing. But for those who are truly long-term oriented, riding through periods of underperformance with tried-and-true strategies will still offer the best chance of building wealth.

This is true even during very difficult periods of underperformance. Take Warren Buffett as an example. Many consider him among the greatest investors ever. Yet, even the Oracle of Omaha doesn't outperform the market all the time. His returns since the bottom of the last bear market in 2009 until the middle of this year lagged the S&P by almost 4.5% annualized. Over the past two and a half years he lagged the market by over 9%.

Those are big differences. But, consider that over the real long-term, Buffett has dominated the market. His annualized returns since 1965 have been twice that of the overall market, and $1,000 invested in Berkshire Hathaway in 1965 would be worth more than $27 million today. Not many stocks, or investors, can make such a claim.

Focusing too much on performance over shorter periods would likely have caused investors to abandon Buffett's strategy at various points over his multi-decade investment career. This would have come at the expense of tremendous long-term performance.

Diversification is no different. Such a strategy looks foolish right now, and it looked foolish during the 1990s, but it would have saved a lot of investment losses when the market turned negative in the 2000s, and I suspect something similar will happen during the 2020s.

Diversification can be applied in different ways. It may mean spreading assets to other asset classes such as bonds, real assets, or even alternative investments. However, even within the stock market, diversification is important. Buying stocks across various industries, sectors, and geographies will be increasingly important.

Value stocks, smaller-company stocks, and international stocks all have lagged domestic, large-capitalization growth stocks lately, but their long-term track records are undeniable. It may be hard for younger investors or Robinhood traders to believe, but these other segments generally have trounced the returns of large-cap growth stocks and the overall stock market.

In fact, Warren Buffett's best returns came from investing in value stocks when they were the most beaten down, during the late 1950s to the late 1960s and from the mid-1970s to the early 1990s. By some measures value stocks are cheaper today than they were during Buffett's heyday.

While investors have pushed up the valuations of the most expensive, least profitable stocks over the past decade, it defies human nature to believe that this will go on forever. Getting the most for our money by purchasing the stock of profitable companies at reasonable prices seems more rational than buying high and hoping to sell higher.

Of course, while it seems obvious that Buffett's beloved value stocks, as well as international stocks and other market segments, will eventually return to glory, no one knows exactly when. The stock market appeared very overvalued in 1996. That was the year that Fed Chairman Alan Greenspan gave his "irrational exuberance" speech, opining on the overinflated value of the stock market. However, stocks continued to rise for 4 more years, and their annualized return over that period was greater than 20%.

Thus, sticking with a proven strategy through up markets and down requires almost superhuman patience. The market may not behave the way we want or in any way we can predict, but its returns over longer periods have proven reliable. There is no reason to believe that has changed, but the best way to earn those returns over time is with a diversified portfolio, even if that appears outdated in certain market environments.

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