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Remedies for Market Volatility

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If you've paid close attention to the stock market over the last three years, you may be tempted to doubt one of the most trusted rules of long-term investors: Diversify.

Because a smarter strategy than diversifying your 401(k) across many sectors of the global economy during that period, in hindsight, would have been to put everything you own into a collection of stocks representing the Standard & Poor's 500.

The major U.S. benchmark outperformed a broad selection of other indexes — including stocks and bonds, foreign and domestic — during the three-year period. In 2015 alone, eight of nine other asset classes, including U.S. bonds, international large-cap equities and emerging market equities, were outperformed by the S&P 500, as shown in the exhibit.

The question we are hearing with increasing frequency is, "Why bother diversifying when the most familiar investment category is the best performing?"

Harry Markowitz was awarded the Nobel Prize in 1990 for his pioneering work on Model Portfolio Theory and wrote extensively about the effects of an individual fund's risk, return, and correlation on the performance of a portfolio of funds.

His work showed that by building a diversified portfolio of funds that do not move exactly together, investors are able to achieve the only "free lunch" — the same return with less risk, or the same risk with more return — available to them in the markets.

Recent market activity has demonstrated that one requirement for the success of Modern Portfolio Theory is patience.

For the past three years, any effort to diversify away from the S&P 500 has hurt a portfolio's performance. Furthermore, certain asset classes that have historically been good diversifiers have recently been moving in sync with U.S. stocks instead of independently of them.

It is perfectly natural to second-guess your investment strategy when things don't immediately go your way. Reacting to the feeling of regret can often lead to investment mistakes.

Historical 401(k) fund flow data show that many investors sell funds at their low point and buy others at their high.

Currently, this means you should fight the urge to sell funds that have been underperforming, such as most international funds. Likewise, now is likely not an ideal time to plunge into funds that have been performing relatively well, like large-cap U.S. growth funds.

Our recommended strategy for long-term investors is to build and maintain a diversified portfolio that employs that mix of stocks and bonds, domestic and foreign, as well as deflation and inflation-sensitive investment funds.

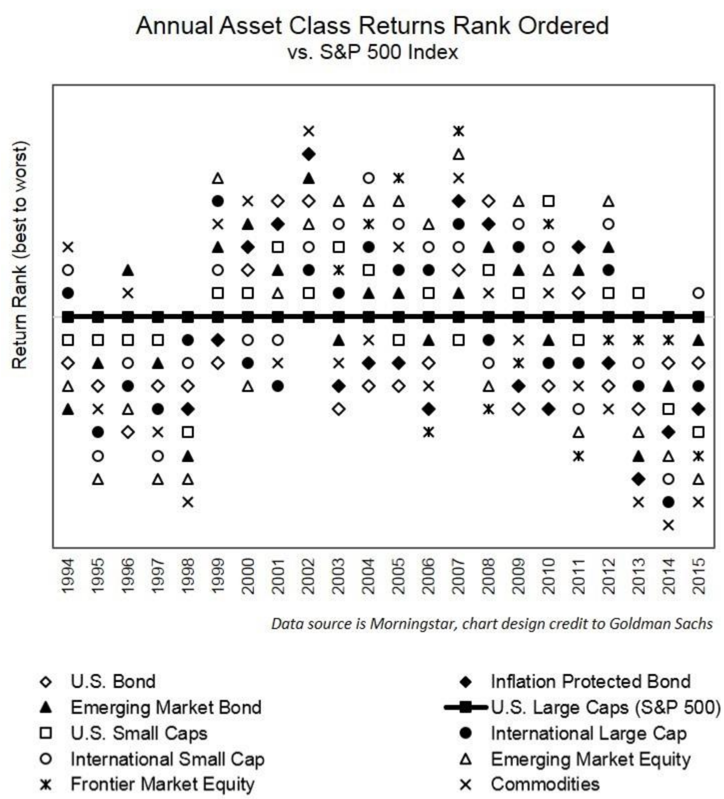
Then, once you have determined the right mix of funds based on your wealth accumulation needs, projected savings rate, proximity to retirement, and risk tolerance, your primary investment decision should be when to rebalance.

Rebalancing is an excellent long-term investment tool because it generally causes you to liquidate shares of funds that have outperformed and purchase shares of funds that have underperformed. This is the opposite of what most investors do and is a time-proven way to improve portfolio performance. Most 401(k) platforms offer an auto-rebalance function that can take care of this task for you. If asked, choose the annual rebalance option.

Dollar cost averaging, the act of purchasing the same dollar amount of shares in a fluctuating market — a practice largely forced upon 401(k) savers —also causes you to buy more shares when prices are down and fewer shares when prices are up. Over time, this reduces your average cost and can increase your return.

The last time U.S. large-cap stocks dominated all other asset classes for this length of time was the late 1990s. But that period of time was followed by a dozen years in which diversification away from the S&P 500 paid huge dividends.

Which means, now is not the time to abandon your diversified investment strategy. Instead, stick with rebalancing and dollar cost averaging.



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