HOW'S THE MARKET DOING?

Global Financial Private Capital

SYNOPSIS

- When asked how "the market" is doing, the question invariably refers to the performance of the S&P 500 index.
- Diversification should occasionally disappoint investors because there will almost always be a few underperformers at any given time.
- While the S&P 500's performance may make for good banter on television, it should never be used to gauge the success of a diversified portfolio over time.

THE MARKET

When asked how "the market" is doing, the question invariably refers to the performance of the S&P 500 index. Since its inception in 1957, it has slowly become the de facto barometer for the overall health of global financial markets.

The index is also one of the most commonly used benchmarks for investors to assess their individual performance. Beat the S&P 500 and not only is one expected to build mass amounts of wealth, but any fees paid to active managers become justified.

The challenge for investors is that the S&P 500 has surged over the last eight years, and many are frustrated to see their portfolios return only a portion of "the market's" performance since the end of the financial crisis.

While it is understandable that investors want to achieve the highest returns possible, the S&P 500 is one of the worst possible benchmarks to use for a diversified portfolio for three reasons:

1. **Concentrated**: The index only comprises 500 large stocks based in the U.S. It is also highly concentrated since it is weighed by market cap. For scale, just four technology stocks (Apple, Amazon, Google, and Microsoft) currently make up more than 10% of the index.
2. **Aggressive**: A portfolio consisting of only equities is nowhere near representative for most investors, particularly retirees because they tend to hold a wide range of investments that are more conservative in nature.
3. **Too Small**: The total amount of investable assets in the world is estimated to be around $300 trillion, but the total market cap of the S&P 500 is closer to $20 trillion. Hence, the index only represents less than 10% of assets invested globally.

Consider a scenario where a conservative investor's portfolio consisted of 30% in stocks and 70% in bonds. Comparing this portfolio to only the S&P 500 would be inappropriate.

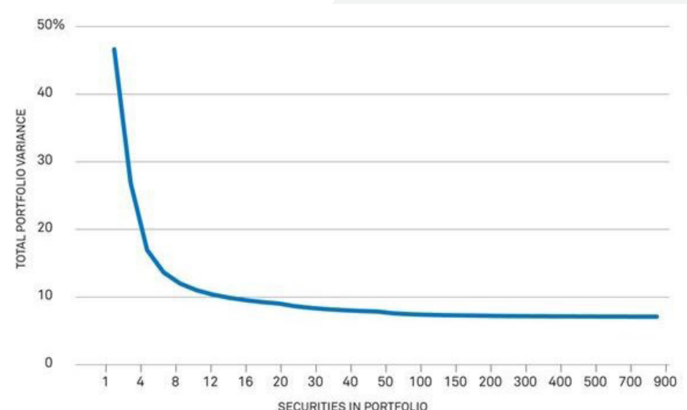
> *"...the S&P 500 is by no means and accurate representation of global financial markets..."*

Furthermore, any investor with a portfolio designed to generate income could never benchmark themselves against an index that is currently yielding below 2% annually and consists of a large portion of non-dividend paying stocks.

Simply put, the S&P 500 is by no means an accurate representation of global financial markets, nor is it a benchmark that should ever be used on its own.

THE GOLDEN RULE

Diversification is this "Golden Rule" of investing, and investors are to maintain broad-based diversification at all times[1]. There is simply no exception, and those who choose to ignore are playing with fire. The chart below demonstrates the importance of diversification by depicting the relationship between diversification and risk.



Source: Modern Portfolio Theory and Investment Analysis, Ninth Edition

Global Financial Private Capital, LLC is an SEC registered investment adviser. SEC registration does not imply any level of skill or training. Investment Advisory Services offered on a fee basis through Global Financial Private Capital. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.

501 North Cattlemen Road, Suite 106 • Sarasota, FL 34232 • Tel: (866) 641-2186 • Fax: (941) 312-6512 • www.gf-pc.com

The vertical axis measures portfolio variance, which is a fancy word for risk, and the horizontal axis counts the total number of securities in a portfolio. The relationship clearly shows that as the number of securities increases, the risk falls exponentially.

Unfortunately, it's not as easy as buying 20 securities and calling it a day. A basket of only healthcare stocks will not diversify an investor all that much. Instead, investors must consider other geographies and asset classes and then monitor how the relationships between these assets change over time.

Another challenge is the emotional toll it creates. A properly diversified portfolio should occasionally disappoint investors because there will almost always be a few underperformers at any given time, but this is the whole point behind diversification.

If we knew up front which investments were going to be homeruns and which would be duds, investing would be as simple as buying the winners and avoiding the losers. Crystal balls are hard to come by in this business, so the next best approach is to manage risk rather than take too much of it.

To achieve this goal of risk mitigation, diversified portfolios often hold investments that are designed to underperform the S&P 500 in a rising market so that it can provide a cushion when our economy falls into a recession.

This yin to the yang produced by the S&P 500 can deliver a smoother ride by mitigating the impact of major drawdowns, like the one in 2008 that drove the index down over 50%. The last thing an investor would want to do is to sell these invaluable tools because they are not keeping up with "the market" when it is rising.

THE RIGHT BENCHMARK

If the S&P 500 is nowhere near an appropriate benchmark for investors, then the question becomes why it is so often regarded as such. I believe the answer is the media.

One of the most fundamental economic principles is that we are all self-interested. We operate our lives and base our decisions on what will best serve us and the people we love. Recognizing this principle is critical to understanding the motivations behind most decisions by not just people but also corporations.

Within this context, the media represents a group of for-profit institutions that are in business to make money. The bulk of their revenues come from advertising, so they are highly incentivized to attract as many eyeballs and website clicks as possible.

More viewers translates to more advertising dollars, so they need to keep their audience hooked so they don't change the channel. The S&P 500 just so happens to be ideally suited to achieve the media's goal for two reasons:

1. **Unpredictable**: The inability to predict what will drive the market on a daily or even monthly basis means that a never-ending supply of storylines is readily available. Much like watching a great mystery, viewers never know what to expect next.
2. **Highly Volatile**: In the short-term, emotions drive stock prices, and few subjects make investors more emotional than their money. The sharp ups and downs cause investors to become fixated on what is moving their nest egg.

If this over-emphasized index is not a good measure of performance for a properly diversified portfolio, then investors need a more appropriate benchmark. The problem is that no universal solution exists because each investor is different.

A benchmark is unique to an individual and should be established in a way that is designed to guide an investor to achieving their long-term return objectives. Fortunately, constructing a proper benchmark is a relatively straightforward task for a trained professional.

IMPLICATIONS FOR INVESTORS

Imagine the opportunity to play a round of golf at Augusta National. For those who do not golf (like me), this is the site of The Masters golf tournament, and most avid golfers would give up their first born to play 18 holes on this legendary course.

Before arriving in Augusta, a golfer would prepare by filling a golf bag with an arsenal of different clubs that all serve a unique purpose. For example, there is a high probability that any golfer, no matter how skilled, will end up in a sand trap at some point. Hence, a sand wedge becomes a necessity.

There will also be a need to hit the ball short distances to the hole, so a putter is another vital club that must be in the bag. Longer shots off the tee will require a driver, and so on.

Global Financial Private Capital, LLC is an SEC registered investment adviser. SEC registration does not imply any level of skill or training. Investment Advisory Services offered on a fee basis through Global Financial Private Capital. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.

The point here is that any serious golfer will bring every possible tool to make the experience of golfing at Augusta as enjoyable as possible (no golfer wants to end up in a sand trap, but they also don't want to ruin their score by leaving their wedge behind either).

Planning for a round of golf is analogous to a long-term investment strategy, and the driver in our investment golf bag is the S&P 500. This "club" hits the ball the farthest and creates the most excitement (any golfer will admit that few things in this world feel more rewarding than hitting a monster drive down the fairway).

However, seasoned golfers also know what can happen if a swing is off by even a millimeter. The slightest mistake can send the ball towards the moon, and it could take several strokes just to get back on course.

The point is that it takes way more than just one club to get through a round of golf, and it most certainly takes more than one investment to help an investor achieve their long-term goals. We need investments that can help us grow our nest eggs over time, but just as important, we need others that can guide us through the sand traps that are pervasive through financial markets.

Furthermore, no golfer beats themselves up for their inability to hit their wedge as far as their driver because a wedge is not designed for long drives. Assessing the performance on the golf course involves comparing a wedge shot to other wedge shots, and a drive to other drives.

The bottom line is that despite the adrenaline rush that comes with a big drive down the fairway, the key to a good score is having a strong short game.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer,
Global Financial Private Capital
mikeonmarkets.com

[1]Diversification does not ensure a profit or gaurantee against loss.

This commentary is not intended as investment advice or an investment recommendation. It is solely the opinion of our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Past performance is no indication of future performance. Liquid securities, such as those held within DIAS portfolios, can fall in value.

Global Financial Private Capital, LLC is an SEC registered investment adviser. SEC registration does not imply any level of skill or training. Investment Advisory Services offered on a fee basis through Global Financial Private Capital. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.