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Factors in Focus

The Endurance of Diversification[1]

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Markets have experienced a lifetime worth of volatility in the last 10 years. While disciplined and well diversified investors have recovered from the turmoil, 15%+ declines in each of the last three years still has everyone on the edge of their seats. Some believe every newsworthy event could lead to another market correction, or worse, a repeat of 2008-like losses.

These significant but temporary declines seem permanently ingrained in our minds, as is the fear of a recurrence. But we forget, or do not know in the first place, that diversified portfolios have always been resilient and exhibited impressive endurance in the face of uncertainty. Even the largest declines have eventually reversed course with losses recovered faster than most realize or remember.

To remind ourselves about the endurance of diversification, we'll look at the ***inflation adjusted total returns*** of the S&P 500 and two diversified portfolios—an "equity" allocation and a "balanced" allocation during five of the worst declines on record.[2]

The Great Depression

Portfolio Mix	1929-1932	1933-1936	1929-1936
S&P 500 Index	-53.2%	+180.7%	**+31.4%**
Diversified Equity Index	-70.3%	+271.1%	**+10.3%**
Diversified Balanced Index	-35.3%	+150.3%	**+61.9%**

1929 saw the worst stock market decline in modern history and a prolonged bout of deflation. By year-end 1932, $1 invested in the S&P 500 was worth only $0.47 on a real basis. The decline was even worse for smaller and more value oriented stocks, which have their worst performance during deflationary times. This caused the Equity Index to lose over 70%, and despite 40% in bonds, the Balanced version shed over 35% of its value.

As losses mounted, hope sank and many people felt the economy had permanently changed. Yet amidst what is considered the roughest economic time in US history, markets looked ahead to recovery and declines were erased within just a few years. By 1936, the S&P 500 and the Equity Index made up all of their lost ground, with the Balanced Index earning an average real return of over 6% per year for the period.

Depression Aftermath & World War II

Portfolio Mix	1937-1941	1942-1945	1937-1945
S&P 500 Index	-38.7%	+110.2%	**+28.7%**
Diversified Equity Index	-43.2%	+222.6%	**+83.1%**
Diversified Balanced Index	-23.8%	+105.4%	**+56.4%**

1937 saw a market backlash as it became clear that the policies of the Roosevelt "New Deal" had failed to spur economic growth. By 1940, World War II was underway, and we entered the conflict late in 1941. Over this five year period, the S&P 500 lost almost 40% of its value, and the Equity Index declined over 43%. Even a sizable bond allocation couldn't keep the Balanced Index from losing almost 24%.

Although the conversion to a wartime economy would revive industrial production and boost employment, investors struggled to see beyond the conflict. But markets marched on. The S&P 500 recouped all of its losses by 1945, with the Equity Index rocketing ahead to a 7% annual real return. Also recovering and outpacing the S&P 500 was the Balanced Index, producing gains of over 5% per year above inflation.

1. *Some content for this article was provided by Dimensional Fund Advisors. This information is for educational purposes and should not be considered investment advice.*

2. ***Equity Index** = 30% S&P 500, 30% DFA US Large Value Index, 40% DFA US Small Value Index.* ***Balanced Index** = 18% S&P 500, 18% DFA US Large Value, 24% DFA US Small Value, 40% 5YR T-Notes. Rebalanced annually; returns are net of the Consumer Price Index (CPI). Index data from DFA Returns Program 2.0.Past performance is not indicative of future results.*

Arab Oil Embargo & Watergate

Portfolio Mix	1973-1974	1975-1978	1973-1978
S&P 500 Index	-48.6%	+28.7%	**-33.8%**
Diversified Equity Index	-46.9%	+100.2%	**+6.4%**
Diversified Balanced Index	-33.1%	+53.6%	**+2.8%**

In many ways, the 1970s were as tough a period economically as any we have experienced. The Middle East war had triggered the Arab oil embargo in late 1973, which drove crude oil prices to record levels and resulted in price controls and gas lines. President Nixon had resigned from office over the Watergate scandal. And inflation was on the rise, reaching double digits by 1974. This took its toll on stocks and bonds, with the S&P 500 and Equity Index both losing almost 50%, and the Balanced Index declining over 30%.

Once again, however, markets looked past our problems. Interest rates rose, bond returns increased, and many businesses were able to raise prices to offset inflation costs leading to increased profits. The large growth-dominated S&P 500 was unable to recoup much of its decline, but smaller and more value oriented stocks proved to be more resilient. By 1978, the Equity Index had more than recovered its losses, and even the Balanced Index snapped back to a positive return.

Dot.com Bust

Portfolio Mix	2000-2002	2003-2006	2000-2006
S&P 500 Index	-42.0%	+55.4%	**-9.8%**
Diversified Equity Index	-11.4%	+103.8%	**+80.5%**
Diversified Balanced Index	+3.7%	+55.6%	**+61.3%**

Despite stratospheric gains during the mid to late 1990s, large growth stocks and tech companies in particular gave everything back during the market decline of 2000-2002. The shock of the 9-11 attacks and the early stages of wars in Afghanistan and Iraq contributed to another episode of 40% declines for the S&P 500. This time, because small and value stocks did not benefit as much from the late-90s tech bubble, they didn't share proportionally in the decline. The Equity Index only lost 11%, with bonds contributing to the Balanced Index earning a 4% gain for the period.

But after just a few years, muted inflation and record earnings allowed even the S&P 500 to mostly recover. Through 2006, the smaller and more value oriented Equity Index continued to excel, producing almost 9% annual real returns for this stretch, with the Balanced Index also outpacing the S&P 500 with returns of over 7% per year even after inflation.

Real Estate Collapse and Financial Crisis

Portfolio Mix	2008	2009-2012	2008-2012
S&P 500 Index	-37.1%	+49.0%	**-6.2%**
Diversified Equity Index	-41.7%	+62.6%	**-5.2%**
Diversified Balanced Index	-19.8%	+39.6%	**+11.9%**

The 2008 financial crisis coupled with a severe economic slowdown led to a one-year decline for stocks on par with the multi-year losses of decades past. Net of inflation, the S&P 500 had fallen over 37% by year end, and the Equity Index lost more than 40%. Despite the strong performance of bonds, the Balanced Index still lost 20% of its value.

While some believed the economy had fallen off a cliff, markets were on their way to a rebound. Just over three years later, even after inflation, both the S&P 500 and Equity Index were on the verge of recovering all their losses. Despite low interest rates, the cushion provided by bonds during the downturn allowed the Balanced Index to bounce back completely.

This brief history of economic and market calamity should remind even the most pessimistic investor about the resiliency of capital markets. Diversified portfolios, even those with healthy allocations to fixed income, have at times sustained staggering losses. But a longer term perspective shows they've also demonstrated remarkable endurance, recovering from even the worst periods in our country's history. Those considering drastic changes based on concerns over Europe, our own Presidential elections, or the "fiscal cliff" would be wise to ask themselves why they think the future will be any different?

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