A Risky Proposition

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As most observers realize, the stock market has been hitting record highs recently and there is a growing chorus of forecasters who are expecting another market "crash" or are saying that the stock market is overvalued and ripe for a correction. As many investors have learned over the past year, being invested in the "market" can mean several different things. One example is the idea that an investor is safe if he or she is invested in an index fund. The idea is that, if you have diversification of reasonable magnitude, you are safe. Unfortunately, in the short-term, that is not true. This year is a good example of that fact. Although 2020 is turning out to be a good year to have invested in the stock market, which stocks you invested in made the difference even when considering investing in an index. For example, even if you took refuge in a well-diversified index fund such as the S&P 500, the year-to-date increase through last Friday was 14.8%. However, the NYSE Composite had risen only 4% while the NASDAQ Composite increased 42.2%! If you decided that investing in sectors rather than indices would improve your portfolio returns, then your risk might have increased depending on the index that you chose. For example, the PHLX Semiconductor index rose 49.5% while the PHLX Oil Service sector fell 42.7%!

One very important aspect of these comparative returns is that they are short-term. If we were to look at just three years, the performance differential among these indices tightened up materially. For example, the annualized three-year return for the S&P 500 was 11.3% while the NASDAQ composite was 22.2%. The most popular of all benchmarks, at least for the Main Street investor is the Dow Jones Industrial Average. Year-to-date that benchmark is up 5.7%, trailing the other indices by a substantial margin as it is for the three-year annualized return of 6.8%. At least in the short run, picking the right index matters.

Once investors decide to go beyond indexed investing and decide to choose an actively managed strategy, there are an unlimited number of risks that can affect the return of a portfolio. We continue to tally these different risks and so far, we are well over 100 that can cause substantial losses. Measuring just short-term volatility is not enough to gauge the true riskiness of an actively managed equity portfolio.

While you can know the volatility risk of an indexed portfolio based on the history of returns, knowing the risk factors of an actively managed portfolio is virtually impossible. For example, the major fund rating agencies gave high marks to one fund we invested in and low marks to another. In the case of the first fund, manager error caused a dramatic drop in the fund and the ratings decline occurred only after the fund had lost a substantial amount of value. The second fund experienced a change in portfolio managers where the strategy of the fund was changed and led to another substantial underperformance. The rating agencies failed to pick up on that change until it was too late. The losses had already occurred.

Assessing risk is a critical factor affecting the long-term returns of a portfolio. Diversification can be a key first step to avoid putting all your eggs in one basket. Many employees of large companies put their retirement funds in the stock of the company only to experience a substantial decline in the value of their investment when the company fell on hard times. Another important factor is knowing if a particular fund or investment takes a "plain vanilla" approach and just invests in stocks without the frills of other derivative investments to improve performance. In the case of indexed investing, at least you can look at the historic returns of an index and estimate what your long-term return could be if history is a good predictor of the future.