

# IS DIVERSIFICATION FINALLY WORKING?



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A WEALTH OF COMMON SENSE  
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## One of the strange subplots of the past decade or so in the markets is that bad behavior has been rewarded.

You're not supposed to chase yield, but chasing yield has worked as interest rates continued to fall year after year.

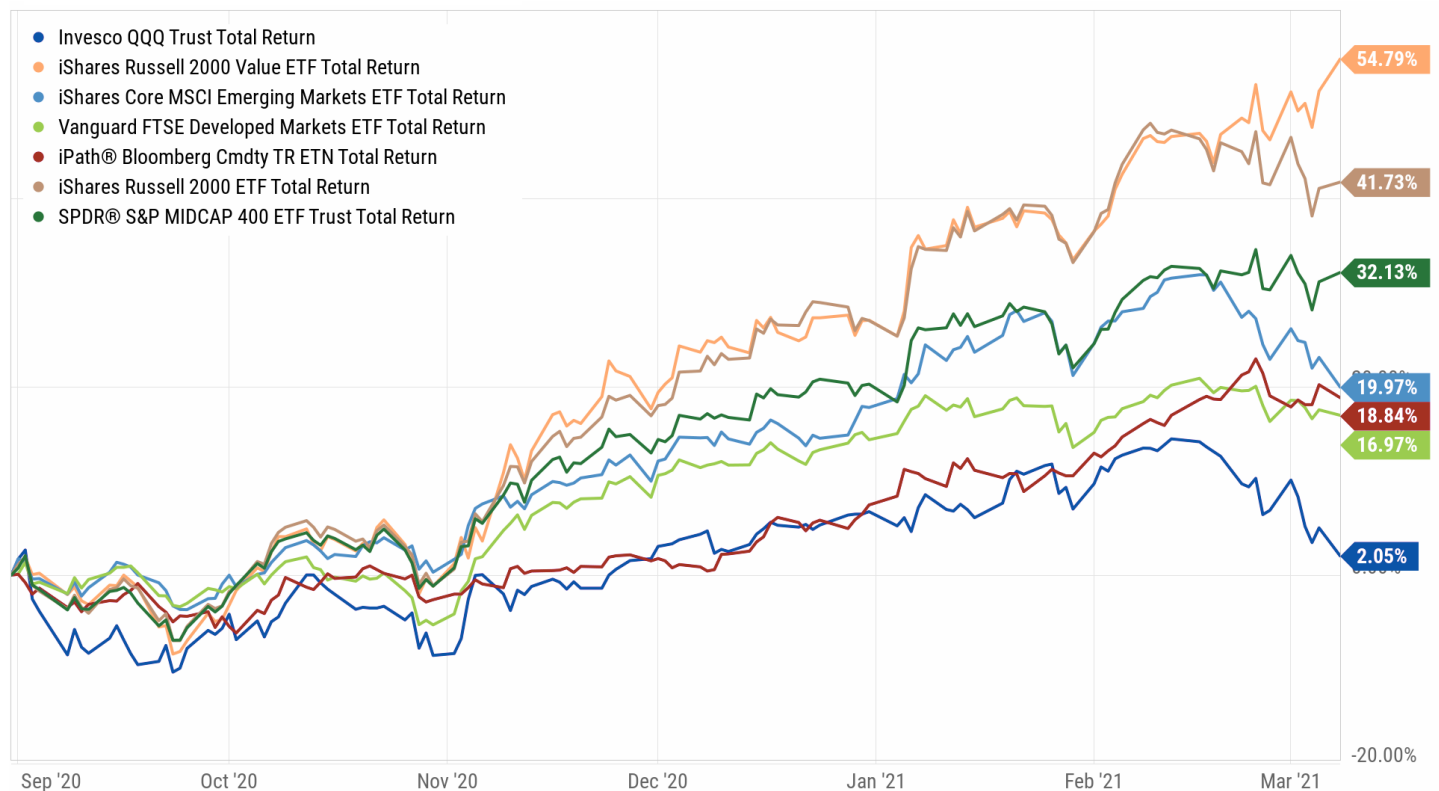
You're not supposed to concentrate in a single region because of home country bias, but the United States has crushed the rest of the world since the end of the 2008 crisis.

You're not supposed to concentrate in a single sector, but tech stocks have dominated every other segment of the market for years now.

The market can stay solvent longer than you can quote Warren Buffett, or something to that effect.

These themes seemed to go into overdrive last spring when the pandemic hit our shores. Tech stocks outperformed during the crash AND the ensuing rally. It didn't seem fair to anyone who owned anything outside of these companies.

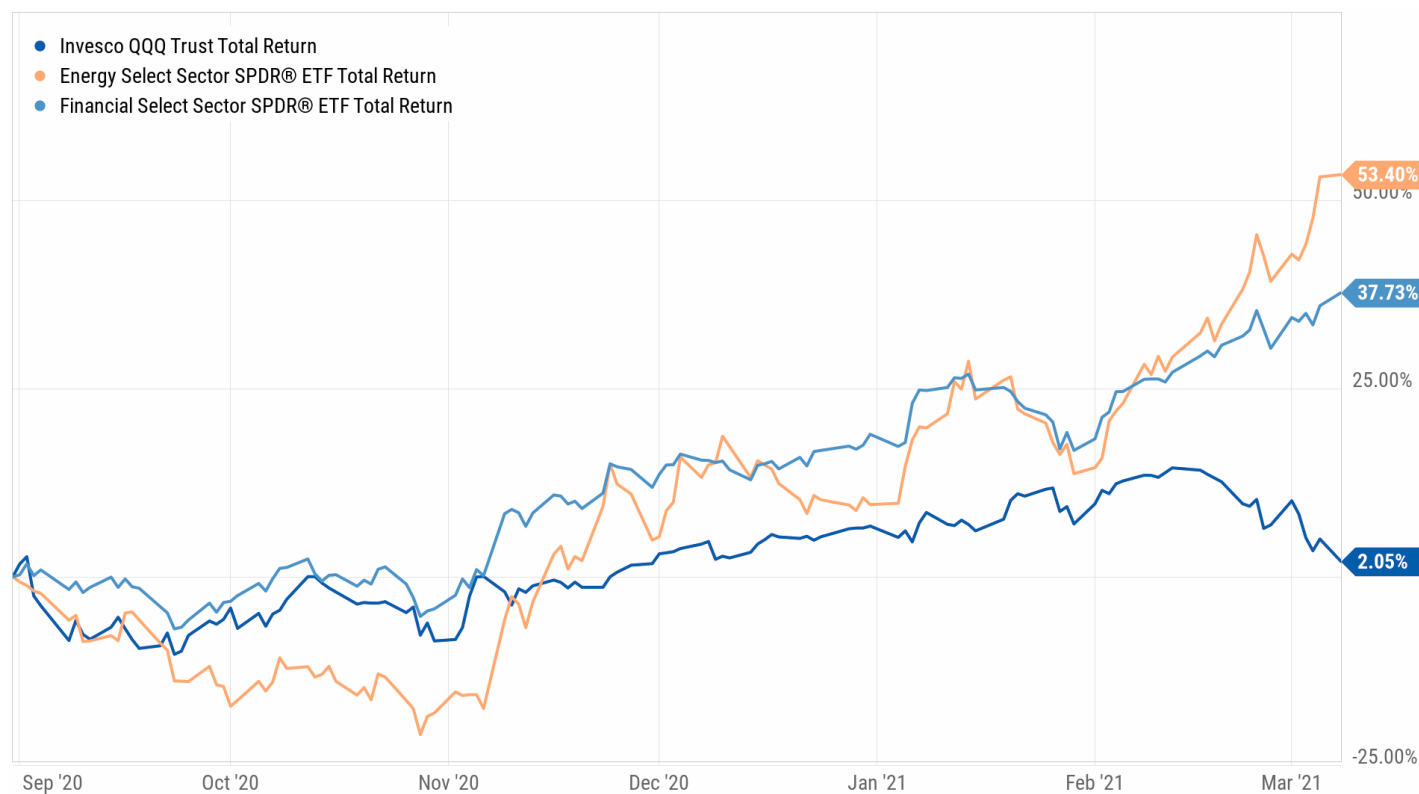
Then, something funny happened around September. Everything else began to outperform tech:



Past performance is not indicative of future results. As of 3/9/21. Source: YCharts.

Small caps, value, mid caps, emerging markets, foreign developed stocks, and even commodities have all outperformed the previous untouchable Nasdaq-100.

Even the former pariahs, energy and financials, have outperformed tech by a wide margin:



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To be fair, this is a six-plus month period. Zoom out over three, five, or 10 years and tech stocks have still annihilated everything. It's hard to figure out trends like these from short-term moves.

Now comes the hard part.

- Is this regime change or a one-time head fake?
- Will fiscal stimulus finally create enough economic growth, inflation, or higher interest rates to make value stocks appealing again?
- Will the dollar roll over so emerging markets and foreign stocks finally outperform?
- Will small caps take the baton from large caps and keep this thing going for another couple of years?
- Are we on the precipice of mean reversion, or is this the meanest reversion that simply goes back to the trend of old?

I don't have the answers to these questions. There are cases to be made for tech to continue its dominance over the market, just as there are cases to be made for the rest of the stock market to outperform in a meaningful way. The hard part is that there are no all-clear signals when investing. There was no catalyst for value to start outperforming and tech to start underperforming. That's typically how this works.

My only answer here is diversification.

Yes, diversification means always having to say you're sorry about something in your portfolio. But, spreading your bets among different parts of the stock market takes away the extremes. While those extremes can include amazing gains, as we've seen in tech stocks for the past 10+ years, they can also include amazing losses.

For instance, from 1995-1999, the Nasdaq Composite Index was up an astonishing 449%, good enough for annual gains of more than 40% per year. Pretty great, right?

That was followed by losses of 39% in 2000, 20% in 2001, and 31% in 2002. That was a loss of 66% in total over a three-year period.<sup>1</sup> Ouch.

Now, the current tech run wasn't exactly the same as the dot-com bubble. There are a number of differences between now and then. But, from 2012-2020, the Nasdaq was up 453% or 21% per year. Those aren't late 1990s annual returns, but more than 20% annual returns over nine years is pretty darn good.

Are we going to see similar losses this time around? I don't know. It's possible. It's also possible mean reversion could see tech stocks underperform on a relative basis to even things out.

Or maybe we really are in a new paradigm where tech stocks outperform all the time.<sup>2</sup>

The point is no one really knows, and anyone that says they do hasn't spent enough time studying market history or human nature. Spreading your money across a wide range of investments, asset classes, and geographies is the ultimate form of saying, "I have no idea what's going to happen in the future."

For those of us who cannot predict the future, we diversify.



To learn more, please contact us at 800-243-4361 or visit [virtus.com](https://www.virtus.com).

<sup>1</sup>And, the peak-to-trough drawdown in the Nasdaq Composite Index was more like 80%.

<sup>2</sup>I don't actually believe this.

The **Nasdaq-100**<sup>®</sup> includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization. The **Nasdaq Composite Index** is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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