MARKET PULSE REPORT

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PATHSTONE FEDERAL STREET

SUMMARY

Over the long term, proper diversification can assist a portfolio's ability to weather and thrive in various environments. But diversification can work against you in the short term.

The vast outperformance of U.S. stocks during this bull market has led some to shun international investments, just as the performance tide may be shifting.

Diversification—the Chickens come Home to Roost

Most of us are familiar with the expression "Don't put all of your eggs in one basket." Sage advice for all walks of life—if the fate of everything is dependent on only one thing--the proverbial basket--then dropping the basket could be catastrophic. The proverb calls for diversifying, or placing the eggs in different baskets in order to reduce the risk of a mishap leading to the loss of *all* your eggs. Simple enough— the concept applies directly to investing. Investor portfolios are often diversified across a wide array of not only stocks (especially for those investing via mutual funds or ETFs), but also various asset classes (such as bonds and commodities) and geographic regions. Unfortunately, to the chagrin of many investors, while diversification sounds all well and good in theory, in practice it often feels as if it is not working.

Now and then, diversification is a drag. At times, the long-term benefits of portfolio diversification can simply be overshadowed by the short-term outperformance of a single security or asset class. How many times have we heard someone lament about a scenario where if they had only put all their money in that hot IPO that posted spectacular gains last year, their returns would be phenomenal?

More realistically (and more applicable to actual portfolio management), many investors have been frustrated during this bull market cycle by the practice of almost any form of diversification away from U.S. stocks. Branching out into other asset

classes has been a drag since the 2009 credit crisis lows as compared to simply holding a portfolio of the largest U.S. stocks.

For example, U.S. equities (as measured by the Russell 3000 Index) have generated an 18.2% annualized return during the eight years since March 2009. International stocks, meanwhile, have generated an 11.1% return over the same timeframe (as measured by the MSCI All Country World Index ex U.S.)—not too shabby but almost 700 basis points lower than the domestic equity market. Last year (2016) was more of the same, with U.S. stocks leading the charge.

A reversal of fortune. The start of 2017, however, is a different story and global diversification may finally be getting out of its funk. Several factors are coming into play: (1) valuations for U.S. investments are getting stretched compared to other regions; (2) the benefits of monetary stimulus have shifted towards overseas markets (the Federal Reserve is at its second year of tightening monetary policy while other central banks are still easing); and (3) currency has not been a steep detractor (when overseas investment returns are converted into U.S. dollar terms). Despite the relatively improved health of the U.S. economy and the prospects of a domestic fiscal boost (deregulation and tax cuts), 2017 is shaping up to be a year where regional diversification pays off. The first quarter of this year certainly tilted that way, with both emerging market and developed international stock returns outpacing the U.S.

Don't call it a comeback. Finally, some may exclaim, diversification is back in style. But in our opinion it never stopped working! True diversification comes from including assets and exposures within the portfolio that have different return drivers, behave differently in various growth/inflation environments, and meet different portfolio objectives. These may include equities (meant to drive portfolio growth), real assets (meant to offset damaging periods of inflation), and bonds (used for stability, income, and to confront slow economic growth and deflationary risks). Exposure across these "buckets"—and to the factors they address—tends to minimize underperformance in extreme environments and lead to more consistent returns over time. The benefits derived from allocating to these diverse and uncorrelated assets, were not diminished simply because U.S. stocks outperformed over a relatively short time horizon. The benefits of diversification were simply less apparent because the risks they attend to did not raise their heads.

Further diversifying across the various equity geographies, capitalization segments (small- and mid-caps), sectors (e.g. energy, financials) and styles (value, growth) may also provide return benefits over time and increase the likelihood of participation in the best-performing assets. But discipline counts when it comes to diversification, as today's leaders may be tomorrow's laggards. For example, last year, value stocks far outpaced growth stocks, while small caps beat large caps. So far, in 2017 it has been the other way around.

As with eggs, proper diversification within a portfolio can substantially reduce volatility and exposure to various risks. While the benefits are not always apparent, unlike bell-bottoms, diversification is never truly out of style. As for whether overseas outperformance continues, we think it is likely over the intermediate timeframe, at least based on our analysis of growth rates and valuations. But let's not count those chickens before they hatch.

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