April: In Times Like These, Remember Our Old Friend Diversification

After posting gains in the first quarter, U.S. equities have reversed course and have started the second quarter in negative territory. Through the first few days of the second quarter, the Russell 3000, a broad measure of U.S. equities, is down about 0.53%, but the more aggressive areas of the U.S. stock market such as small-caps, biotech and technology stocks have seen the brunt of the recent sell-off. As we have noted in previous market commentaries, 2014 will likely be a year of elevated levels of market volatility and diversification will be the most prudent investment strategy.

There are many possible reasons for the recent sell-off in more aggressive U.S. equities including the Fed reducing stimulus, increasing tensions in Ukraine, and a sharp decrease in S&P 500 earnings estimates since the beginning of the quarter. Last week’s employment report further drove the point to investors that the Fed’s tapering program will continue. Given that the Fed’s three quantitative easing programs helped to drive market returns over the past few years, tapering or the reduction of these programs, is increasing investor angst. Uncertainty regarding Russia’s next steps in Europe has furthered market uncertainty.

While tapering was expected going into 2014 and it is always difficult to quantify effects of geopolitical risk on financial markets, the recent reversal in corporate profits has been of even greater concern. According to Thomson Reuters, since the beginning of the quarter there has been a sharp reversal in the share-weighted earnings for the S&P 500. Nine out of ten S&P 500 sectors have experienced downward revisions to estimates with the Materials and Information Technology sectors recording the highest percentage declines. Since stock prices tend to track earnings growth and earnings growth has risen by double-digits for each of the past five years, this reversal is a growing concern to investors. With earnings season likely to start this week, we will be closely watching profit reports.

Because of these concerns, investors have been targeting the more aggressive areas of the markets. For example, the NASDAQ Composite Index fell 2.6% on Friday and is now down 5.2% from its bull-market peak on March 5th. This index tends to hold larger allocations to more aggressive sectors, such as Information Technology and Biotechs, while having a smaller capitalization bias. In times of investor bearishness, small caps tend to underperform large caps. On the other hand, the more conservative S&P 500 is only 1.4% below its April 2nd record high.

Given market weakness and increased volatility, investors should remember to be diversified in their portfolios. A diversified investment strategy strives to smooth out portfolio returns so that the positive performance of some investments will neutralize the negative performance of others. For U.S. investors, diversification did not work in 2013 as U.S. equities far outperformed nearly every other global asset class. Unfortunately, many investors moved away from this strategy and have struggled as last year’s laggards, including international equities, emerging markets equities, commodities, and REITs, have outperformed domestic equities during this current weakness.

We continue to believe in the merits of diversification despite last year’s setback. Outside of overall diversification, we remain focused on those portfolio biases that we laid out at the beginning of this year. These biases include a tilt to large cap U.S. equities, a slight increase in international developed equities, an income focus through dividend stocks and spread product in bonds, and liquid alternative investments.
This information compiled by Cetera Financial Group is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The information has been selected to objectively convey the key drivers and catalysts standing behind current market direction and sentiment.

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