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Diversivindication

"The reports of my death have been greatly exaggerated" – Mark Twain

Until very recently investment performance has been all about the US stock market. No one seems to care about p/e ratios, lackluster growth, significant unemployment, rising interest rates, continued deficit spending, etc. The investment thesis for the past four years has apparently been "if you think it's bad in the US, you should check out [insert country here]". It's really been more about the fact that things seem less *worse* here in the US than in many other places. Many see us as the cleanest shirt in the dirty shirt drawer. Awesome.

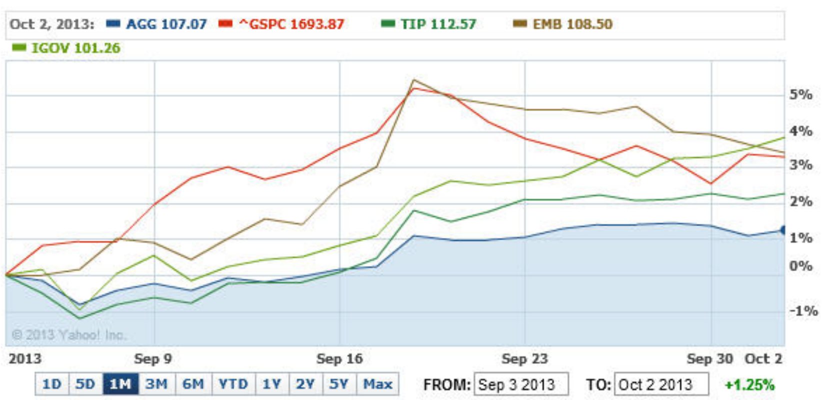
When stocks are priced to perfection (the average price earnings ratio for the S&P 500 stocks is closing in on 20) it doesn't take much to upset the apple cart. Enter the government shutdown. Chasing performance works really well until it doesn't. For the past four years all you really needed to know about investing was the symbol for the S&P 500 (GSPC by the way). That trend has continued this year.

The above graph shows the relative return of the S&P 500 (red line) versus the developed countries international stock markets of Europe, Asia and the Far East (blue line) and the emerging countries stock markets of Brazil, Russia, India and China (green line). As you can see through yesterday's market close (October 2nd) the US stock market, as measured by the S&P 500, was still handily in the lead. If we take a look at a more recent time period though, we begin to see a different trend emerge.

In the past three months it has been the international markets that have taken the lead. Why? Because most of the value has been driven out of US stocks based on their current prices. Money is beginning to flow to other countries that are perceived to offer greater value.

Fixed income (bonds) has suffered even more than international stocks since the beginning of the year with losses across the spectrum.

Again, the S&P 500 is the red line with major bond indexes represented by: the US bond aggregate performance (blue line), US Treasury Inflation Protected Securities (dark green line), developed international country bonds (light green line) and emerging markets bonds (brown line). Citing this trend line, many "experts" have pronounced fixed income DOA. It appears, however, that it still has a pulse.



In the past month bonds have jumped in value. Much like in stocks, it has been the international bond markets that have led the way, outperforming even the US stock market over the past 30 days.

Unless there is a significant shakeout between now and the end of the year, the US stock market will have been the top performing stock market for three years in a row against six other major international stock market indexes. How long that trend will continue is anyone's guess, but it certainly won't be forever. For the eight year period of 2002-2009 the US stock market placed either dead last (four years) or second to last (three years) against these six markets. The only year that it beat most of the other markets was in 2008, when it had the dubious distinction of losing *only* 37% landing it in second place behind Japan (down 29%)

Diversification is not dead. In fact it has a steady sinus rhythm. Perhaps it is for this reason that it is so tempting to abandon it for other ideas that seem so pulse pounding. Who wants to sit around waiting for long term reasonable returns when there is the potential for excitement around every bend? The problem, of course, is that excitement can turn to panic in a heartbeat. When that happens, slow and steady looks pretty vibrant.