One of the most memorable experiences for a teenager after reaching the age of 16 is getting his or her driver’s license, and hopefully a car. For parents, the experience is memorable for different reasons. The thought of their child let loose on the open road for the first time and surrounded by the risk of other drivers can be terrifying. These children, whose parents have raised and protected them for 16 years, are now facing a vastly larger world than can be controlled.

For parents with the means, one way to attempt to mitigate this risk is to buy their child the safest possible car on the market. In 2019, one of the top-rated cars for safety is the Honda Accord. Some of the Accord’s features include the Honda Sensing® suite, which bundles advanced safety and driver-assistance features such as automatic emergency braking, lane-keeping assist, adaptive cruise control, and road-departure mitigation. Moving up from the base model, one can add features like blind spot monitoring and rear cross traffic alert assist. Overall the National Highway Traffic Safety Administration rates the Accord five out of five across all safety ratings.

The 2019 Accord will cost the parents $25,000 to $40,000, based on trim and features. Depending on one’s priorities this may be a lot, or it may be reasonable. However, we can all agree that there are perfectly suitable vehicles for a 16-year-old for a much lower cost. The fact that there are choices means there are tradeoffs. Opting for a lower cost vehicle may mean less safety features and more wear and tear on the vehicle, but that choice provides an immediate benefit of a smaller cash outlay. Opting for the safest vehicle may give greater peace of mind and actual enhanced protection in an accident, with the immediate cost of a higher cash outlay. Knowing which tradeoff is best, however, isn’t known until the future.

Only at the end of the car’s use can the tradeoff decision truly be evaluated. If the parent opted for the pricey Honda Accord and their teenager experienced multiple accidents, it was money well spent. However, if their teenager was an excellent driver with a perfect record, they likely overspent for that protection. On the flip side, if they opted for the lower cost vehicle and their teenager was an excellent driver, they were shrewd decision makers. If their teenager was not a safe driver, they may regret not having spent more for a safer car.

There is an analogy here to portfolio construction. The type of car in our example relates to the type of portfolio investors may construct. The Honda Accord is like a well-diversified portfolio with safety features to protect in the bad moments. It may be more expensive not only because of the cost of the underlying investments, but also the lack of participation if the equity market has a perfect record. The lower-cost vehicle in our example is like a lower-cost equity portfolio, constructed with little concern about recessions or bad markets, less diversified, and perhaps concentrated in a narrow asset class like U.S. equities. Not only is it cheaper to implement, but it may generate large returns in a strong equity market.
With advanced knowledge, the choice is easy. If the parents can see into the future and know that their child will not have any accidents, they should buy the cheaper car. If investors can see into the future and know that the market will not experience any downturns, they can concentrate their portfolios into equities without worry. Unfortunately, the crystal ball hasn’t been developed for either scenario.

Without advanced knowledge, a parent may decide that the risk of a bad outcome is not worth taking, and opt for the safer car. Even at the end of the “investment period”, they are unlikely to regret their decision even if their child had no accidents. The money was spent to protect something they value.

Many MRA advisors have distinct memories of 2009, after the financial crisis and the second worst period for U.S. equities. Very few clients and investors at that time had an appetite for stocks. They had just experienced the emotional trauma of a severe decline in portfolio value and did not want to experience that again. Without advanced knowledge that the following ten years would deliver the longest bull market for U.S. equities (up more than 300%) on record and nearing the longest economic expansion (117 months) in history, most investors opted for a safer, more diversified portfolio to protect something they valued greatly.
Yet a decade later, it was the wrong decision. It turns out the market from 2009-2019 was far safer than anyone predicted, and most investors (who were clients of advisors) overpaid for safety. Their portfolios likely cost more than a simple U.S. equity portfolio, and they missed out on a portion of the upside of the U.S. equity market over that time period.

For investors, the decision in 2009 to opt for safety is far easier than it is in 2019. In 2009 the risk of equities was very real and tangible. It can be compared to shopping for a car with your 16-year-old six months after he or she crashed your car while driving with a learner’s permit. A safer portfolio was a no-brainer. Today investors are not only dealing with the fact that equities have been half as risky over the last decade (relative to long-term history), they’re also dealing with the regret of opting for safety when it wasn’t needed.

In recent months we have challenged all of our assumptions and conclusions and, as part of our 2019 asset allocation study, we have sought expert opinions from key sources in the investment research industry. We intend to make minor changes to our fixed income exposure, but we continue to believe portfolios are well positioned to deliver an attractive return over the long term while providing needed protection in challenging markets.

Without advanced knowledge, we don’t know if remaining diversified for the next decade will lead to the best outcomes. The U.S. equity market may continue to expand well into the future, leaving us and our clients with less return than a concentrated portfolio. In the face of uncertainty, we believe our objective is to prudently focus on protecting and growing our clients’ wealth.

In a 2013 blog post http://jasonzweig.com/saving-investors-from-themselves-2/ Jason Zweig of the Wall Street Journal shared how he was once asked how he defined his job. He said, “My job is to write the exact same thing between 50 and 100 times a year in such a way that neither my editors nor my readers will ever think I am repeating myself.” He then added, “That’s because good advice rarely changes, while markets change constantly.”

Each quarter we write a commentary for our clients that almost always ends the same way: We believe diversified portfolios are the best way to balance protecting assets and growing a portfolio to meet client objectives. With constantly changing markets that provide no certainty, diversification is good advice. On a year-by-year basis, there will be investments that outperform the broader market and others that underperform. For diversification to truly work, investors have to accept and embrace that fact. When bad markets occur and diversification works, it will bring great relief, like the moment the teenager is spared injury in an accident because of the safety of his or her car. Parents don’t hope for their teenager to get in an accident to prove they made the right decision in buying the safer car, just like we as advisors don’t hope for bad equity markets to prove the value of diversification. However, if either occurs, no one will regret choosing to embrace safety first.