William Bernstein wrote, as it related to investing, “The only black swans are the history that investors have not read.”

Black swans are a metaphor for rare events, ones that come as a surprise.

Silicon Valley Bank (SVB) is the most recent example. It was likely the fastest bank failure—from rumor to demise—in American history. It’s rare for a bank to fail and certainly came as a surprise. But the rare and unexpected occur more often than we think.

This is a feature of markets and investing, not a bug. From time to time, problems should be expected—an inescapable part of life.

Recently, there’s been no shortage of them. Inflation, interest rates, and recession-mongering captured most of last year and followed us into this year. Now add a banking crisis to the mix.

What Does the Future Hold?
The easiest thing that can be said is: Handicapping an outcome is no easier than picking winners in March Madness. ESPN reported 20 million brackets were filled out on its website for the event, yet only 37 picked the Final Four correctly. Sometimes the consensus choices aren’t necessarily the correct ones.

There are a couple easy things to remember in times like these:
1. The best investment opportunities mostly arise from fear and pessimism.
2. Diversification is not an accident; it prevents investors from being overexposed to any single outcome.

Like an airplane, diversified portfolios are meant to withstand turbulence, and can potentially help investors avoid any single point of failure.

And this will remain true even in a scenario where more problems arise from SVB’s ashes.

Could a Banking Crisis Lead to Other Problems?
Warren Buffett has the old saying, “There’s never just one cockroach in the kitchen.” The banking crisis has many people asking, “What’s the next domino to fall?”

Rumors are flying that commercial real estate could be in trouble.
The banking industry and commercial real estate are closely connected. The logic goes:

Banks increased their exposure to commercial real estate heading into the pandemic, particularly in metro areas in things like office space and retail.

Now a record number of commercial mortgages are expiring this year, roughly $270 billion worth per Trepp. And most of these loans are held by small banks (those with less than $250 billion in assets), according to the Wall Street Journal.

SVB’s collapse was triggered by unrealized losses from its bond portfolio. Potential losses from commercial real estate loans — in the event of defaults — could create further problems.

Borrowers’ ability to make good on those loans is a worry. Rising interest rates plus falling demand for commercial real estate (areas like retail and urban office space) could create price declines.

This potentially creates two main worries for banks:
1. Defaults rising
2. Real estate prices falling

In both scenarios, banks’ commercial debt portfolios would fall in value. And both of those may feed off each other. Lower prices create more defaults as more borrowers go underwater.

In summary, fear is palpable. Consumer sentiment reflects this, hovering near all-time lows.

**Exhibit 1**: Consumer Sentiment, University of Michigan Consumer Surveys

Source: Clearnomics, University of Michigan

Investor data shows the same result. American Association of Individual Investor (AAII) data shows the percentage of investors who are “bullish” (i.e., optimistic) hovering near multidecade lows.
Diversification Keeps Investors in the Game

In Morningstar’s case, most of our portfolios have some exposure to banks, and the consequence of that will likely be price declines if the current situation worsens. However, the impact of these bank holdings is limited by the high level of diversification in each portfolio.

Diversification is often talked about from 20,000 feet — owning a collection of stocks, bonds, and maybe even alternatives.

But a core Morningstar belief is that portfolios should be diversified within asset classes as well.

Using stocks as an example — Morningstar is diversified across regions, countries, sectors, and company size.

For reference, the U.S. only makes up 60% of the globe’s total equity market. There’s ample opportunity to invest outside the U.S. — and benefits for doing so — as international and emerging markets will likely outperform U.S. stocks again in the future, even though the past decade has fooled some into believing otherwise.
Exhibit 3: Global Equity Market Cap by Size

Source: Clearnomics

Digging further into the U.S., we not only own banks, but a collection of other industries so that financials only make up a small part of the total allocation.

Our investment teams also spend considerable time analyzing the overlap in each individual position as well. For example, using financials, how does JPMorgan (a money center bank) share overlap with Fidelity Information Services (a software provider to banks)?

And while banks have come under pressure, and may remain so, areas of the equity market like communication services, consumer staples, and healthcare have been sources of strength over the past few weeks. It’s possible they remain so.

In short, diversification — done well — has many layers that compound on one another to create a resilient foundation, capable of handling any market environment.

In any given year, when the annual returns of the year’s biggest winners are published, practitioners of diversification are usually not on that list.

Howard Marks talked about this reality in 2017 on the podcast “Masters in Business,” stating:

“Early in my career, I went to the Midwest and met with the head of the pension fund for General Mills. He explained to me over the 14 years he had run the fund his performance was never above the 27th percentile or below the 47th percentile in any year. As a result, he idled near the middle in terms of performance versus peers over those 14 years. The funny math about our business is he ended up in the 4th percentile for the entire 14-year period.”

The lesson: Investment performance consistently in the 50th percentile can end up in the top 5%-10% over long periods.
Marks went on to add:

“I met with another manager later on who told me if you want to be in the top 5% of money managers, you have to be willing to be in the bottom 5% from time to time. To which I thought, how wrong can you be? My clients don’t care if I’m in the top 5%, and they’re absolutely unwilling to be in the bottom 5%. I like the other approach where you’re steadily above the middle, and that pushes you toward the top over the long run.”

A second lesson: Most people who do really well for a while eventually shoot themselves in the foot, and the effects on long-term performance can be significant.

Diversification can be viewed as a form of delayed gratification. The benefits may not be easily identified in any single year, but the long-term benefits are enormous.

**Diversification Creates More Consistent Outcomes**

To use a golf analogy, putting the ball in the fairway is likely the biggest predictor of success. In investing, diversification helps investors find the fairway.

Any single year of great investment performance is akin to birdieing a hole in golf; it’s nice, but the 18-hole scorecard is what really matters. For many of us, birdies are hard to replicate. They only come around so often.

As can be observed below, investing follows a similar track. 2022’s “birdie” was commodities, up 16% for the year. But look at how commodities performed in years prior. Among major asset classes, commodities were the worst performer in seven of the ten years prior to 2022.

**Exhibit 4: Asset Class Performance, Total Returns**

![Asset Class Performance Table]

Source: Clearnomics

If you only play for birdies, you’re bound to end up with bogeys or worse on many other holes. Meanwhile, a diversified approach (measured by the balanced portfolio) provides a more consistent outcome, helping you find the proverbial fairway.
Given recent events, the future feels incredibly murky, but this is not abnormal. The future is always highly uncertain.

Zooming out from present and thinking about the future, the chart below is one of best illustrations of the power of long-term thinking.

**Exhibit 5. S&P 500 Total Return: Rolling Periods % Time Positive**

Source: Morningstar Direct. Indexes shown are unmanaged and not available for direct investment.

On any single day, it’s basically a coin flip whether the market will be up or down. But the further you extend the time horizon, the better your chances become.

Now parallel the above with what’s happened in recent weeks. Certain parts of the market have exhibited casino-like characteristics. It’s been normal to see +/-20% stock price moves for banks in the line of fire from the SVB fallout.

It’s important for investors to know they don’t have to play that game. The stock market is only a casino if you allow it to be.

There’s a much simpler game to be played, which boils down to the timeless investing principles of ignoring short-term noise and focusing on the long-term probabilities of success.

Diversification is likely the greatest tool for enabling that long-term success, helping investors withstand painful drawdowns that happen from time to time, keeping them invested, and ultimately tipping the odds in their favor.

Nobody can predict the future, but we know panic is not an investment strategy; neither is “get me in” nor “get me out.”
Luckily, if you’re diversified, you don’t need to predict the future. Diversification is not accident. III

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A debt security refers to money borrowed that must be repaid that has a fixed amount, a maturity date(s), and usually a specific rate of interest. Some debt securities are discounted in the original purchase price. Examples of debt securities are Treasury bills, bonds, and commercial paper. The borrower pays interest for the use of the money and pays the principal amount on a specified date.
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Based on a proprietary valuation-driven asset-allocation process, our strategies offer investors a range of multi-asset, risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers’ best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey matters.

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