Trends and Takeaways From 2017's First Half

As you conduct a midyear portfolio review, a rundown of the key forces affecting its performance.
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"Your portfolio is like a bar of soap. The more you handle it, the smaller it gets."

This will always be one of my favorite pieces of investment wisdom. Not only is it folksy and easy to relate to, but there seems to be quite a bit of truth to it. In my experience, hands-off investors are invariably more successful--not to mention more relaxed--than those who are too plugged in and active with their holdings.

Yet even hands-off investors should make a habit of checking up on their portfolios every so often--quarterly, semiannually, or annually at a minimum. They should also articulate the frequency of details of those checkups in an investment policy statement.

If you're surveying your portfolio at midyear, here are some key trends to be aware of--forces that have likely affected your portfolio's performance, for better or worse. I've also weighed in on what--if anything--you should take away from those trends.

Trend: Stocks continue to outperform other asset classes.
Much has been made about what it means that bond prices have gone up right alongside stocks this year. But even though the two asset classes have gained ground, stocks have thumped bonds and certainly cash over every trailing period in sight. For the first half of the year, the S&P 500 gained more than 9%, whereas the Barclays Aggregate returned just 2%.

Takeaway: Revisit asset-class exposures.
With the current rally in stocks in its eighth year, investors who haven't revisited their asset-class exposures should consider doing so now. A hands-off portfolio with 50% in the S&P 500 and 50% in a Barclays Aggregate Index tracker at the outset of the current equity market rally in 2009 would now hold roughly three fourths of its assets in stocks and the remainder in bonds. In addition, Morningstar's analysts believe their broad coverage universe is looking a bit pricey today, based on their estimates of various stocks' fair values. Meanwhile, we're all eight-plus years older than when the rally began, and most portfolio plans call for larger weightings in cash and bonds as retirement approaches.

Plugging holdings into the Morningstar X-Ray and comparing asset-class exposures to targets can help identify what--if any--changes are needed in light of the ongoing strength in the equity market. If it's time to lighten up on stocks, stay attuned to potential tax consequences. Selling appreciated stocks may trigger capital-gains taxes, which is why it makes sense to concentrate rebalancing efforts in tax-sheltered accounts.

Trend: International stocks are outperforming, finally.
Investors who have kept the faith and hung onto their international stock holdings despite foreign stocks' long-running underperformance relative to U.S. equities are being rewarded in 2017. The MSCI EAFE index of developed foreign stocks returned about 14% through the year's first half, and many emerging markets, especially in Asia, have gained even more. However, as senior analyst Bill Rocco points out in this article, a good share of the gains enjoyed by foreign stock mutual funds has come from appreciation in foreign currencies relative to the dollar--not just appreciation of the securities themselves. The hedged version of the MSCI EAFE index returned about 5 percentage points less than the aforementioned unhedged version in 2017's first half.

Takeaway: Revisit equity allocation, but focus trimming on the U.S. piece.
Despite the rally in foreign stocks so far in 2017, it was preceded by a period in which foreign stocks badly lagged U.S.: Broad foreign stock indexes--whether they track the MSCI EAFE index or a benchmark that encompasses both developed and developing markets stocks--have performed worse than the S&P 500 in seven of the past 10 years. Moreover, most investors, U.S.-based or otherwise, have a significant home-market bias, meaning that their portfolios are less diversified than they ought to be. (Morningstar's director of global ETF

research Ben Johnson discusses that phenomenon in this article.) Thus, even though foreign stocks have rallied so far this year, it's a rare U.S. investor whose portfolio tilts too heavily toward them. Investors who need to reduce equity weightings overall should begin trimming with the U.S. portion of portfolios rather than the international piece.

At the same time, be sure to maintain realistic expectations for foreign stocks. True, some market experts see better upside potential for foreign stocks, especially emerging markets, over the next seven to 10 years. But it's worth noting that the aggregated price/fair values for various foreign geographies within Morningstar's equity coverage aren't appreciably--or in some cases any--lower than is the case for U.S. stocks. Moreover, if U.S. stocks fall--and Morningstar's equity analysts due see U.S. equity prices as lofty today--it's a rare scenario when foreign stocks don't lose, too.

Trend: Growth stocks have crushed value.
In contrast with international stocks' strong short-term performance, the year-to-date strength of growth stocks is part of a longer-running phenomenon. While value stocks enjoyed a brief snap-back following the election, performance has fallen into a more familiar pattern for the year to date, with growth stocks once again trouncing value. Through June, the S&P 500 Growth Index returned a full 7 percentage points more than its growth counterpart, thanks to soaring performance from large constituents like Apple AAPL, Amazon.com AMZN, and Facebook FB. This phenomenon isn't new: The S&P 500 Growth Index has returned fully 4 percentage points more, an on annualized basis, than the Value Index over the past decade. Growth stocks have maintained a similar edge in the small- and mid-cap realms, as well as overseas, albeit to a lesser extent than with U.S. large caps.

Takeaway: De-risk by trimming growth stocks.
Some market watchers have been discussing whether the strength in growth stocks is part of a more lasting phenomenon in which market leaders like Apple continue to gobble up their competitors' lunches; John Rekenthaler took a closer look at the debate here, and waded into it here.

Given growth stocks' long-running outperformance, I'd be inclined to be a little more hands-on with a portfolio that's tilted heavily toward them at this juncture. The simple reason is that the downside potential of betting heavily on growth and being wrong probably outweighs the return advantage you stand to gain by letting your growth winners ride. Check your portfolio's investment-style distribution in Morningstar's X-Ray tool. If it's listing heavily toward the right (growth) side of the style box, that could indicate that your portfolio is courting excessive valuation risk by too heavily emphasizing the market darlings.

Trend: Despite Fed action, bonds haven't performed all that poorly.
The Federal Reserve Open Market Committee has hiked interest rates four times since the end of 2015. But despite a lot of hand-wringing over the past several years about what higher rates would mean for the bond market and bond prices, the bond market has dealt with the Fed's actions in a very orderly fashion. True, long bonds have taken some hits, but the impact on the average investor in a core intermediate-term bond fund has been pretty minimal: Investors in these products have earned roughly their yields--not a lot more, not a lot less--over the past three years.

Takeaway: Keep the faith in bonds--and bond funds.
Of course, bonds' recent returns are no great shakes. But I continue to believe that the main role for bonds and cash in a portfolio is to serve as shock absorbers during periods when equities are falling. Of course, it's possible that a spike in inflation could cause the Fed to take more aggressive action that could catch the bond market off guard, thereby spelling trouble for bond prices. But investors who focus on short- and intermediate-term bonds and bond funds for their core fixed-income holdings won't likely experience extreme volatility, while earning a better return than cash over time.

Trend: Cash yields have popped up.
Cash yields remain stubbornly low--even below the inflation rate, actually. But the Fed's actions have had a silver lining for savers, in that higher yields have been coming online. With an online savings account, you can

pick up a yield of as high as 1.25% today, and many money market mutual funds are also getting closer to the 1% yield mark.

Takeaway: Revisit liquid reserves.
I don't know about you, but I've gotten a bit lazy about my cash holdings over the years. As cash yields have slunk lower and lower, it has been hard to get excited about transferring money out of my minimally earning checking account at the bank and into a higher-earning alternative. But as yields on some cash options pop above 1%--and stand to go even higher if the Fed continues to nudge rates up--it's worth the effort to wring a competitive yield out of liquid reserves. This is particularly important if those reserves are significant--for example, if you're using the bucket strategy to manage your retirement portfolio or you're holding money aside to make a big purchase within the next few years.