During the third quarter most investors posted positive results on the back of solid economic data and generally strong earnings results. However, across the various asset classes performance was mixed. U.S. large-cap stocks led the way posting high single digit returns, while U.S. small and mid-cap results were approximately half that of the large-cap index. Looking beyond the domestic market, developed international equities managed a slight gain but emerging market indexes turned lower due to several factors including the sharp decline in Chinese markets. As the global equity markets experienced a historical bifurcation in returns, the domestic bond market was little changed on a total return basis. Unlike last year when a diversified portfolio boosted overall performance as non-U.S. markets outpaced returns at home, so far this year most asset classes other than U.S. stocks have weighed on overall performance.

Investors should understand that there will be periods when one asset class or market segment significantly outperforms and it can become challenging to remain diversified. One of the first lessons new financial advisors are taught is how to explain (and justify) diversification. While overly simplified, the one analogy that I find resonates with investors is that of a driver in bumper-to-bumper traffic. I am sure you can relate to the situation where you are sitting in traffic watching the lane next to you seemingly move much faster than your own. After watching a dozen or so cars move past you, you quickly change lanes in an effort to join the quicker flow of traffic. However, seemingly as soon as you switch lanes the lane you just merged into is now stopped and you are caught watching the lane you just left move quickly ahead of you. This phenomenon is often observed in investors chasing the hottest sector or asset class by moving their allocation from stocks to bonds, large-cap to small–cap, or from growth stocks to value, etc. Just as it becomes "obvious" that one area is doing much better than others, investors make the change only to find they switched at exactly the wrong time. Dalbar Inc, an independent company focusing on financial services audits and evaluations, conducts an annual study comparing average investment returns of various mutual funds to the results experienced by the average investor. In their 2016 study Dalbar found the average investor trailed the average investment return by an annualized amount of almost 3%. The study's conclusion remains that most of the underperformance is due to investors' inclination to sell stocks or funds that have recently done poorly and in turn to buy stocks or funds that have recently done well. As any investor knows this is the exact opposite of the adage of buy low and sell high.

RiverGlades does not have a proprietary crystal ball used for forecasting returns or implementing large shifts in asset allocation. Rather the firm seeks to identify an appropriate long-term target allocation for each client based on their respective goals, needs and risk tolerance. Then over the course of time small tactical changes are made at the margin to increase allocations to asset classes and sectors that are believed to present more favorable returns while also reducing allocations to asset classes or sectors that fundamentals or macroeconomic factors imply might have less favorable returns in the coming quarters. This strategy aims to improve the investor's overall return over time while maintaining appropriate diversification and thereby avoiding the folly identified by Dalbar's studies. RiverGlades investment approach seeks to enforce a level of discipline that is believed to shift the likelihood of success in the client's favor.

The quarterly commentary over the past few quarters has sought to highlight a focus on finding a smoother path of returns as opposed to targeting a total level of return. It was stated that RiverGlades' approach was increasingly focused on offsetting potential near-term volatility and that the strategy may rise in importance should the equity markets stumble. As I write this commentary in early October, the S&P 500 just experienced a sharp sell-off over the past few days including a single day drop in excess of 3%. While the recent spike in volatility and decline in global equity markets is not expected to mark a change in the ongoing secular bull market, it did serve to confirm that our focus on volatility is warranted.

Certain investment approaches or market segments may generate larger returns from time-to-time. However, an appropriately diversified portfolio constructed on fundamentals and adjusted to the intermediate term macroeconomic trends remains a time-tested way to generate reasonable rates of return with lowered levels of risk.