FACTORS IN FOCUS

March 2019

The Race Is Not Always To The Swiftest

by Eric D. Nelson, CFA

As I sat in the crowd watching my son Tyler on stage for his first-grade rendition of *The Tortoise & The Hare*, next to my daughter Payton, who was outsinging her older brother despite still being a year away from her big moment, my mind drifted to another iteration of the classic tale.

My former colleague at Equius Partners, Jeff Troutner, had written a newsletter (link) in mid-2001 with the same title as the Aesop's Fable. It had a significant impact on me when I was still new to asset class investing. Barely a year after the collapse in technology stocks following the unprecedented dot-com run up throughout the 90s, Jeff had explained how all of the return advantage for the NASDAQ and the S&P 500, thanks to a significant overweight in high flying growth stocks, had disappeared by the summer of 2001. Stodgy, old-economy laden large and small cap *value* stocks had pulled ahead over the entire period going back to 1995. It was the classic tale of slow and steady winning the race—how *discipline* and *structure* eventually trumped stock market *euphoria*.

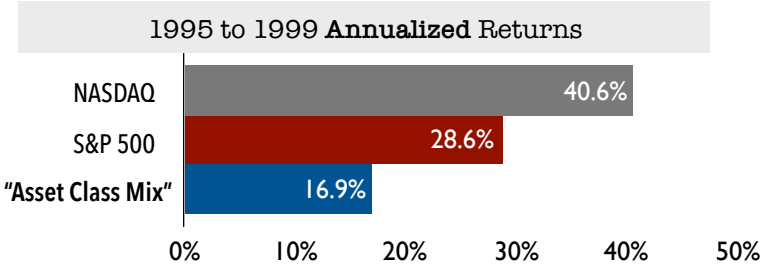
I filed the thought of that *Asset Class* newsletter and the Tortoise & Hare theme away in my memory bank, never suspecting that it would continue to be a useful example almost two decades after the obvious lessons we learned from the 1990s growth stock boom and bust.

But here we sit today, in early 2019, with the rearview mirror showing a sizable advantage over the last five years for the NASDAQ and high-price, growth stock-dominated portfolios relative to their smaller and lower-priced, value-stock counterparts that have had the obvious historical advantage over longer periods. Once again, globally diversified asset class investors are finding their discipline and resolve being severely tested.

In honor of Tyler's big night and Jeff's newsletter I first came across over 15 years ago, I want to retell the story of the *financial* Tortoise & Hare.

The Go-Go Growth Years (1995 to 1999)

The late 1990s were something to behold for growth investors. The S&P 500 Index appreciated at over 28% per year, a return almost three times its long-term historical average! But the S&P 500, with just a *bias* towards large growth technology stocks, paled in comparison to the full-blown growth dominated NASDAQ. Over 2/3 of that index was invested in tech stocks, helping propel it to over 40% annual gains. Every $1 invested in the NASDAQ in 1995 was worth over $6 by early 1999!



On the other side of the market, smaller and more value-oriented stocks in the US, which had the upper hand for 70 years compared to the market and high-priced growth stocks, couldn't keep up. International stocks did even worse compared to their domestic counterparts. A globally diversified "asset class" portfolio*, with significant amounts of large and small cap value stocks in US and non-US markets, didn't perform badly, but at just +17% per year, it seemed decidedly out of step with the "new era" of technology and stock trading.

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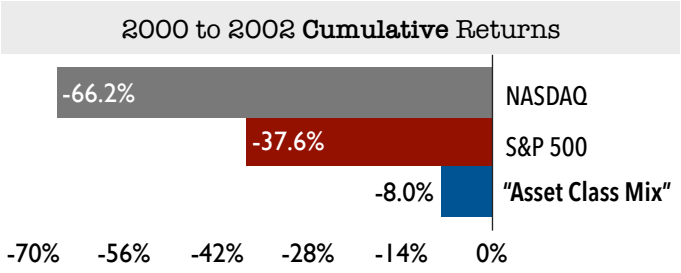
The Tech Stock Collapse (2000 to 2002)

2000 ushered in a new century and the end of the growth stock surge. Tech stocks started heading lower in early 2000, blowing past a 10% correction faster than anyone expected and by the fall of 2000 they were firmly in bear market territory. Then something unexpected happened—the long-overdue downturn turned into a collapse. The love for high-flying growth stocks completely disappeared.



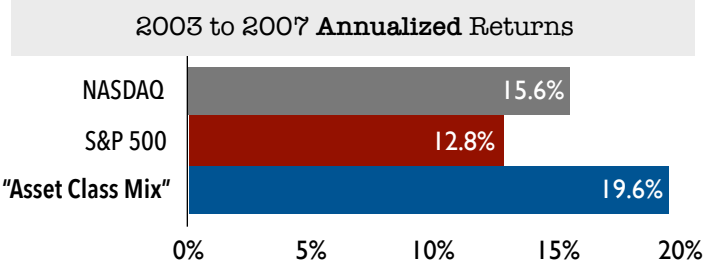
From 2000 through 2002, the NASDAQ lost -66%, rivaling the decline on the broad market during the 1929-1932 Great Depression! The S&P 500 Index didn't escape unscathed, falling almost -38%.

Beyond US large cap growth stocks, most other asset classes, including US and non-US large and small cap *value* stocks, held up much better. Some even had *positive* returns. The Diversified Asset Class Mix only lost -8% cumulatively over the 2000-2002 period.

Now, including the 1990s run, the NASDAQ was no longer in the lead. After the sizable losses, it had just a +8.1% per year return from 1995-2002. The S&P 500 Index had fallen to +10.2% per year, and the Diversified Asset Class Mix, that started so far behind, had almost caught up, with a +9.2% per year return.

A Different Kind of Bull Market (2003 to 2007)

The post-2002 bull market proved that tortoise-esque smaller and more value-oriented stocks, as well as global diversification, also had some legs. From 2003 through 2007, the Diversified Asset Class Mix returned +19.6% per year. The NASDAQ and S&P 500 Index also did well at +15.6% and +12.8% annually, but neither matched the high returns from smaller and lower-priced stocks globally.



Over the entire period, including the extreme short-term swings in both directions, stock returns settled in as history would have predicted. Despite the lightning fast start, the high-flying NASDAQ came in last at **+10.9% per year**, with the S&P 500 Index only slightly ahead at **+11.3% per year**, weighed down by an overabundance of high-growth companies. Finally, proving that it's not how you start but how you finish, the Diversified Asset Class Mix, with a much more reasonable allocation to high-priced growth stocks and a much greater emphasis on smaller and lower-priced value stocks across the globe, came out ahead at **+13.1% per year**. $1 invested in the NASDAQ grew to $3.84, in the S&P 500 Index it grew to $4.01, and $4.93 in the Diversified Asset Class Mix.

Keep Your Eyes On The Prize

Will history repeat? Will we see the large lead that NASDAQ and S&P 500-centric strategies have built relative to diversified, small cap and value-oriented allocations since 2014 evaporate? No one can say for sure but if history is any guide, it's only a matter of time. What we learned from the 1995-2007 period as well as many before it, as the last line in *The Tortoise & The Hare* reminds us, is the investment race is not always to the swiftest. The highest long-term returns don't always materialize in every period, and the only way you can assure yourself of earning the entire return of any asset class, especially higher-expected returning small cap and value stocks, is to stick with them and even rebalance during periods when they are out of favor or declining.

Consistency is key in terms of sticking with your plan and the philosophy you've decided is best suited for your goals. Simply put: invest like the Tortoise, not the Hare.

***Diversified "Asset Class" Mix**: 21% DFA US Large Company fund, 21% DFA US Large Value fund, 28% DFA US Small Value fund, 18% DFA Int'l Value fund, 12% DFA Int'l Small Value fund. Rebalanced annually.

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