

# Factors In Focus



## Sixteen Years Gone

by Eric D. Nelson, CFA

In the late 1990s, investors had no reason to consider historical market returns. For the five-years ending in 1999, the S&P 500 returned +28.3% per year, turning \$1 into \$3.48. The tech stock-heavy NASDAQ Index did even better, returning +40.6% per year, turning \$1 into \$5.50. Even going back 18 years to 1982 and the start of the longest running bull market for stocks in modern history, the S&P 500 returned +18.5% per year. Every \$1 invested in the S&P 500 was worth a whopping \$21.31 less than two decades later. Investing seemed as easy as throwing money at a handful of blue chip US stocks, or buying a basic index of them. The notion of diversifying geographically and including smaller and more value-oriented stocks appeared pointless—almost nothing provided meaningfully higher returns than simply owning the S&P 500.

The 16-year period ending in 1981 told a very different story. Investing wasn't quite *that* easy, and the S&P 500 wasn't always such a sure bet. The chart below tells the story of this difficult stretch for stocks in contrast to the 1980s and 90s.

From 1966-1981, the S&P 500 didn't even keep pace with inflation, falling behind by 1% per year. The +6% per year return before inflation was barely enough to outpace short-term bonds (Five-Year Treasury Notes).

So why am I dredging up this decades-old data? Because experienced investors know, *then as it was, then again it will be.*

Sure enough, we have just completed another 16-year period beginning in 2000 with similar results for the S&P 500. This time, using the live mutual funds from Dimensional Fund Advisors (DFA) as our asset class proxies, we can observe a wider set of investment returns.

Table 1 on the next page reports, from 2000-2015, the S&P 500 once again failed to outperform short-term bonds. Those who expected to be bailed out by traditional diversification, adding large cap stocks in Europe/Asia (EAFE) and emerging markets, were disappointed. International developed market stocks actually did even worse than the S&P 500, returning just +2.3% per year, and emerging markets managed only 1.6% higher returns but with double the volatility.

Chart 1: Periodic Annualized Asset Class Returns (1966-1999)

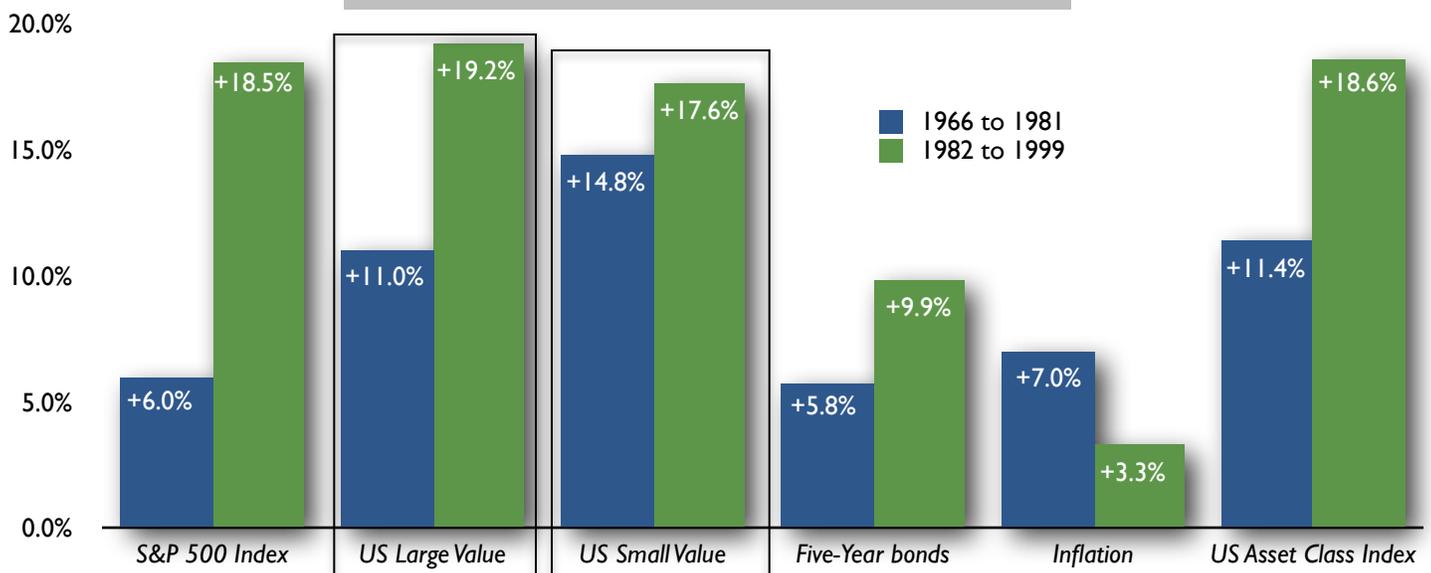


Table I: Periodic Asset Class Returns Since 2000

Asset Class/Portfolio Mix	2000-2015	2000-2013	2014-2015
DFA US Large Co. (S&P 500)	+4.0%	+3.6%	+7.3%
DFA US Large Value	+7.7%	+8.3%	+3.1%
DFA US Small Value	+10.3%	+12.2%	-2.3%
DFA Large Cap Int'l (EAFE)	+2.3%	+3.3%	-4.1%
DFA Int'l Value	+5.0%	+6.8%	-6.7%
DFA Int'l Small Value	+9.9%	+11.5%	-0.6%
DFA Emerging Markets	+5.6%	+7.8%	-9.0%
DFA Five-Year Global Bond	+4.1%	+4.4%	+2.2%
Global Asset Class Mix	+7.7%	+8.8%	+0.3%

As was the case during the 16-year period from the mid-60s to the early 80s, it was only the added diversification of large and small *value* asset classes that propped up stock portfolios. Since 2000, US large value companies have outperformed the S&P 500 by 3.7% per year, US small value companies have outperformed by 6.3% per year. In non-US markets, large value stocks beat the EAFE Index by 2.7% and small value stocks returned 6.6% more per year.

A diversified portfolio consisting of the S&P 500 as well as US and non-US large and small value stocks (“Global Asset Class Mix”) produced a +7.7% per year return. That was 5.5% per year more than inflation, even more robust than the +4.4% real return generated by the US Asset Class Index the last time the S&P 500 floundered (see chart #1).

Achieving the superior long-term returns of a diversified asset class portfolio isn’t as simple as the periodic data would suggest. Asset class investors have learned this lesson the hard way through experience over the last two years. The table above also reports the last 16 years broken down into two different periods—the long stretch where diversification worked brilliantly (2000-2013), and the inevitable period where the S&P 500 was by far the best performing asset class (2014-2015).

Because this recent two-year stretch is the one that almost all of our clients have experienced, I thought it was important to point out the randomness and occasional disappointment in short-term relative returns. The globally diversified asset class portfolio, after losing ground in 2015, is barely positive over the last two years. This return isn’t overly disappointing—no one expects to make money every single year or two. But when compared to the +7.3% per year return on the

S&P 500, more than one client is understandably feeling a twinge of regret.

No one can say for sure how long markets will struggle or when small cap, value and geographical diversification will begin to pay off in terms of higher returns. History has clearly taught us that shifting more towards a concentrated S&P 500-like portfolio (or any asset that has performed relatively well) after a few years of outperformance can lead to disastrous results.

So the message for 2016, like 2015 and all the years before it, is to stay diversified and stay disciplined. Your portfolio has been designed with your most important long-term goals in mind.

If those haven’t changed significantly, your asset allocation should not either. Eventually, I believe, we will be handsomely rewarded for the decisions we’ve made.

Remember—*rivers always reach the sea.*

**Source of asset class return data:** DFA Returns 2.0

**Chart I:**

US Large Value stocks = DFA US Large Value Index

US Small Value stocks = DFA US Small Value Index

Five-Year bonds = Ibbotson Int’l Treasury Index

US Asset Class Index = 30% S&P 500, 30% US Large Value stocks, 40% US Small Value stocks; rebalanced annually.

**Table I:**

Global Asset Class Mix = 21% DFA US Large Company fund (DFUSX, DFLCX prior to 2010), 21% DFA US Large Value fund (DFLVX), 28% DFA US Small Value fund (DFSVX), 18% DFA Int’l Value fund (DFIVX), 12% DFA Int’l Small Value fund (DISVX); rebalanced annually.

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