Chasing Returns: Avoid the Next Financial Cliff

By Kimberly Sterling

In the past few years, US stocks have registered strong gains. Yes, there was the ugly dive in September and October of 2014. Even so, US large growth stocks were up 62% from the beginning of 2012 through December 2014. US large value stocks were up 76% for the same time.

During this same time, other asset classes (international, emerging markets and REITs for example) have underperformed US large and large value, or they have performed inconsistently. The result is that for the past three years, a globally-diversified portfolio has underperformed US large growth and US large value stocks.

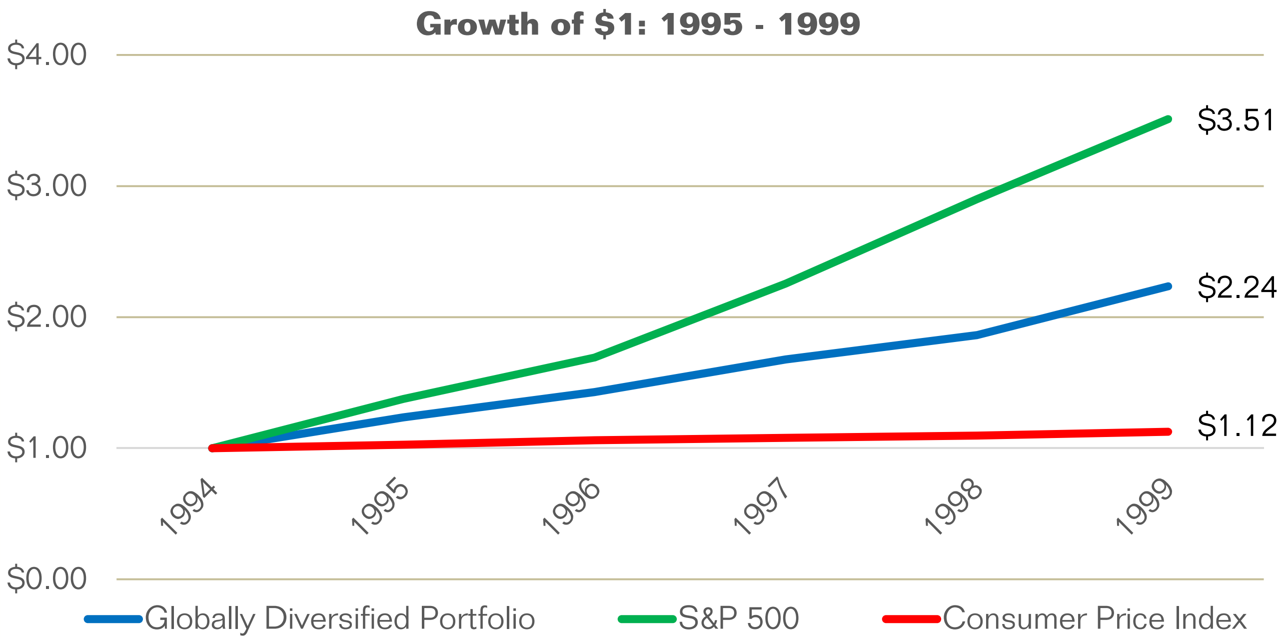
This is not unusual. And it isn't even a problem. The problem arises when the global investor *thinks* there is a problem and decides to follow the herd, sometimes over the cliff.

The field of behavioral economics reveals that humans are hard-wired to look for patterns, and then react based on their observations. Unfortunately, short-term patterns in the stock market are often inconsistent with the long-term fundamentals needed for success.

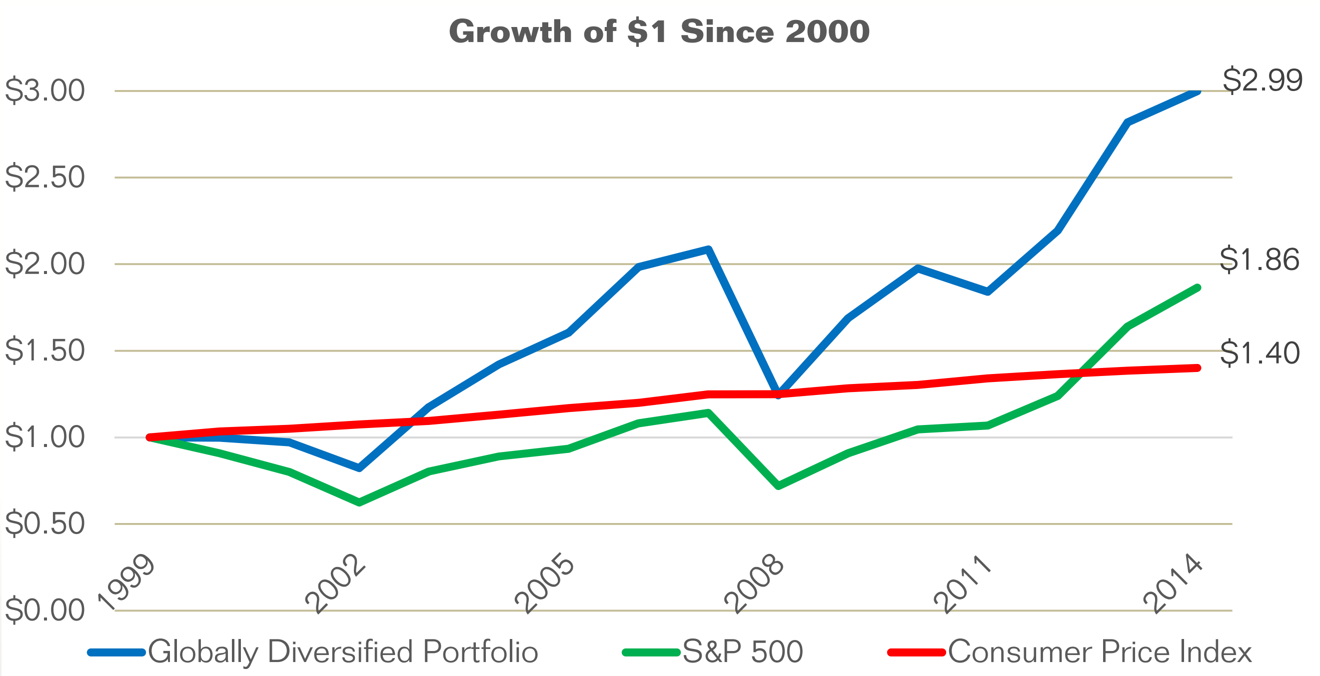
Another behavioral economics tendency is to follow the crowd (the herd). Especially when the crowd is broadcasting or bragging about their short-term success. Many of the braggarts don't even know their long-term rate of return! But that doesn't stop them from sharing their irrational exuberance. Or worse, when something scary happens, sharing their dire warnings of danger. "Look out! The sky is falling! Buy gold!"

Evidence-based investing demonstrates that the best opportunity for long term success comes from a low-cost, low-turnover, globally-diversified portfolio – especially one that is tilted toward asset classes with stronger risk/return performance. Tilts include: value stocks, small-company stocks, international stocks, real estate investment trusts and emerging market stocks. In most short periods (2 to 4 years), there are one or two asset classes outperforming the others. Right now it's US large and US large value stocks. But over a longer timeframe, a globally-tilted portfolio will have a better risk/return profile. How much time is enough? Usually almost any 10-year period will do it.

Let's look at a classic example – the high tech boom that started in 1995. For the five year period from 1995-1999 the S&P 500 significantly outperformed a global portfolio and inflation (see graph below). The S&P 500 annual returns ranged from 21% to 37%. Whereas the globally-diversified portfolio annual returns ranged from 15% to 23%.[1]



As we all know, the tech bubble ended with a dramatic crash in 2000. From 2000 through 2012, the S&P 500 didn't even keep up with inflation (see graph below). It wasn't until 2013 that the S&P 500 finally outperformed inflation during this timeframe.[1]



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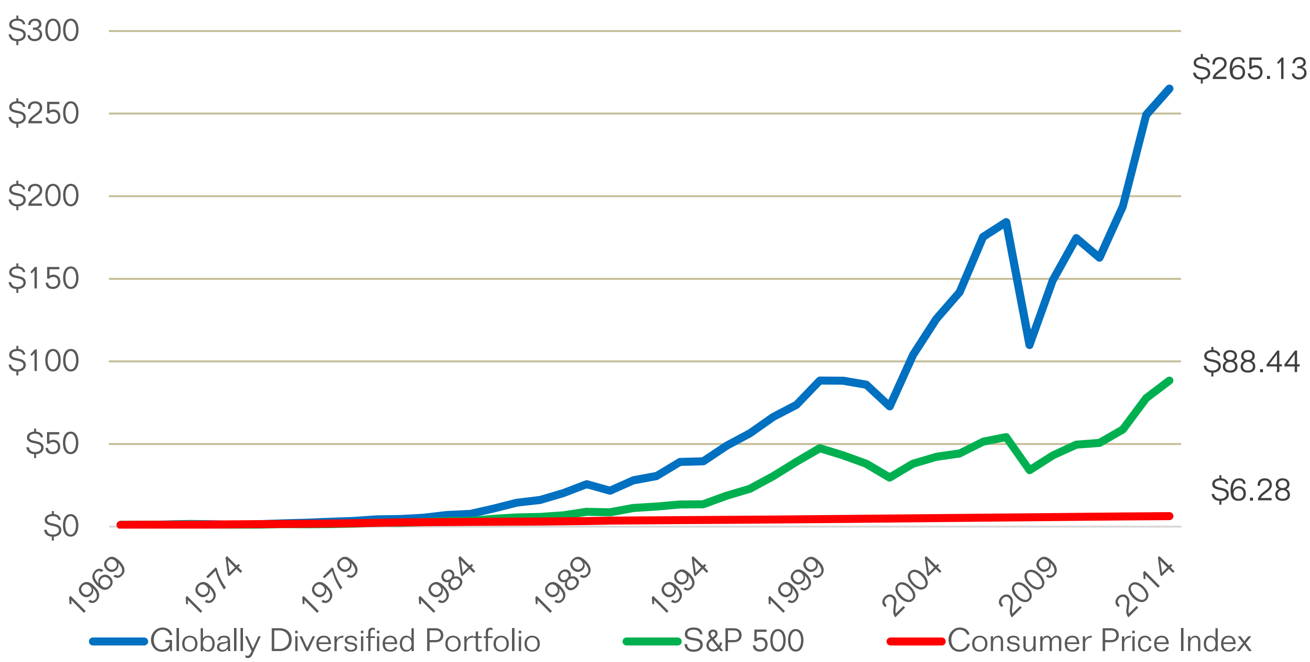
During the first five years of the tech bubble, many investors became convinced that it was a new world and a global portfolio was a poor choice for the long run. Sadly though, it was just another of many historic bubbles that pulled unwary investors over a cliff. As you can see, a globally-diversified portfolio handily outperformed both the S&P 500 and inflation during this timeframe.

To see the bigger picture, and to give you comfort that this isn't just data mining, let's step back and look at longer-term results going back to 1970.[1] Again, a globally-diversified portfolio handily outperformed both the S&P 500 and inflation (see graph below).

Growth of $1 Since 1970



We can clearly see the long-term benefit of a globally-diversified portfolio. However, you may still be thinking, "Surely there's something that can be done to improve returns and take advantage of US outperformance during a time like this." Yes, there is: sell high and buy low. Otherwise known as rebalancing. Here's a recent example.

For the year ending 2013 there were some incredibly strong asset class returns: US large value was up 40.6% and US small growth returned 42.7%. And there were some duds: real estate investment trusts (REITs) were up 1.4% and emerging markets core down 2.6%. This provided a ripe environment for rebalancing.

At RCG, we look at portfolios every week. It's a fluid situation requiring monitoring, measurement, and judgment. During 2013 we found opportunities to scrape the profit from the winners and invest in the underperformers mentioned above. It's important to note that when evaluating rebalancing opportunities, we take into consideration each client's cash flow needs, tax issues and other unique circumstances.

As we progressed through 2014, US small growth was slightly negative at 0.08% and US large value was up 9.9% through August 2014. However, the duds from 2013 were outperforming. REITs were up 21.6% and, emerging markets core were up 11.7% through the same time period. This presented us with another opportunity to rebalance accounts and harvest gains from the then outperformers. This isn't market timing, it is disciplined rebalancing.

This is the kind of activity that's continually going on behind the scenes at RCG. Academic papers[2] have estimated that this kind of rebalancing can add 0.50% to 0.80% to returns annually. That adds up over time and this is just one example of the small ways RCG adds value.

In addition to the small ways we add value and reduce costs, we hope to add immeasurable value by keeping clients from chasing the 40% returns right over the cliff.

Talk to your advisor if you'd like more details. With practice, it will become easier NOT to second-guess a successful long-term strategy during these times.

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[1] Sources: Dimensional Fund Advisors, Inc. (DFA). **US Large** - Standard & Poor's 500®. **US Large Value** - Fama-French Large Value Research Index (1970-2013) Russell1000 Value 2014. **US Small** - Fama-French Small Cap Index (1970-2013) Russell2000 2014. **US Small Value** - Fama -French Small Value Research Index (1970-2013) Russell2000 Value 2014. **Foreign Large** - MSCI EAFE (net) from 1970-1974 and MSCI EAFE (net) Growth from 1975 - 2014. **Foreign Large Value** - MSCI EAFE (net) from 1970 - 1974 and MSCI EAFE Value (net) from 1975-2014. **Foreign Small** - DFA International Small Simulated Index (1970-2013) MSCI World ex USA Small Cap Index 2014. **Foreign Small Value** - DFA International Small Simulated Index from 1970-1981, DFA International Small Value Simulated Index from 1982-2013, and MSCI World ex USA Small Cap Index 2014. **Emerging Markets** - DFA International Small Simulated Index from 1970-1987 and MSCI Emerging Markets Index from 1988 -2014. **REITs** - Fama-French Small Cap Index from 1970-1977 and Wilshire REIT Index from 1978-2014. **CPI-** CPI actual 1970-2013. CPI 2014 is estimated.

This diversified portfolio is a hypothetical portfolio assuming 20% US Large, 20% US Large Value, 10% US Small, 10% US Small Value, 7% Foreign Large, 10% Foreign Large Value, 5% Foreign Small, 5% Foreign Small Value, 8% Emerging Markets and 5% REITs.

[2] Journal of Financial Planning, January 2008, "Opportunistic Rebalancing: A New Paradigm for Wealth Managers"

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