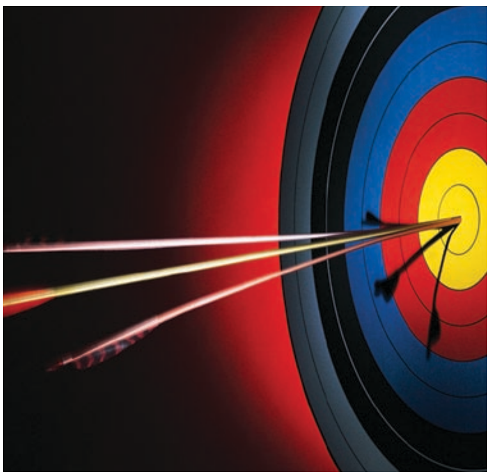


Consistency Matters

Which asset classes have performed the best over the past four decades?

By Craig L. Israelsen

Age and experience tend to refine our perspective. What might be boring to the young is praised as consistent by the old. I must be old because I really value consistency.

How consistent have the seven major asset classes been over the past 40 years? To answer this question, let's take a look at their performance over the past four decades: the 1970s, 1980s, 1990s and 2000s. (The 1970s consist of the 10-year period from Jan. 1, 1970, to Dec. 31, 1979, and so on.) The asset classes we will examine are large U.S. equity, small U.S. equity, non-U.S. equity, U.S. bonds, U.S. cash, real estate and commodities.

In addition to these seven individual asset classes, we will also study the behavior of a multi-asset portfolio consisting of equal allocations (14.3%) in all seven assets. The multi-asset portfolio was rebalanced at the end of each year.

This particular analysis will consider 10 annual investments of $1,000 each within each of the four decades being studied. Rather than simply making a single investment at the start of the 10-year period (the typical assumption driving all published returns), this study will assume an annuity investment that simulates how most people actually invest in their retirement accounts—that is, they invest periodically rather than simply making a single lump-sum investment.

The S&P 500 Index served as a proxy for the 40-year historical performance of large-cap U.S. equities, while the Ibbotson Small Companies Index from 1970-1978 and the Russell 2000 Index from 1979-2009 captured the performance of small-cap U.S. equities. The Morgan Stanley Capital International EAFE Index (Europe, Australasia, Far East) represented the performance of non-U.S. equities.

U.S. bond performance was captured by the Ibbotson Intermediate Term Bond Index from 1970-1975 and the Barclays Capital Aggregate Bond Index from 1976-2009. (As of late 2008, the Lehman Brothers indexes were renamed the "Barclays Capital" indexes.) Three-month Treasury bills represented the historical performance of cash.

The performance of real estate was measured by using the annual returns of the NAREIT Index (National Association of Real Estate Investment Trusts) from 1970-1977 (annual returns for 1970 and 1971 were regression-based estimates, since the NAREIT Index did not provide annual returns until 1972). From 1978-2009, the annual returns of the Dow Jones U.S. Select REIT Index were used (prior to April 2009 it was known as the Dow Jones Wilshire REIT Index). Finally, the Goldman Sachs Commodities Index (GSCI) measured the historical performance of commodities. As of Feb. 6, 2007, the GSCI became known as the S&P GSCI.

DECADES OF DIFFERENCE

Not surprisingly, the results were strikingly different from decade to decade (see "Winners by Decade," at right). Here are some highlights:

• **The 1970s.** The 1970s was the best decade for small U.S. stocks and commodities. Real estate was next, and then came the multi-asset portfolio. Large U.S. stocks and cash had the same ending outcome. The laggard asset class that decade class was U.S. bonds.

Nevertheless, all seven individual asset classes finished above water. That means that the ending account balance was larger than the total amount of $10,000 invested (as calculated by a $1,000 investment at the start of each year for a period of 10 years).

A multi-asset portfolio consisting of equal allocations in all seven asset classes (and rebalanced at the end of each year) was a solid performer. In fact, the multi-asset portfolio outperformed large U.S. stock, non-U.S. stock, bond and cash.

• **The 1980s.** This decade was the heyday of non-U.S. stocks. The MSCI EAFE Index dominated all other six asset classes. Large U.S. stocks did well, as did commodities.

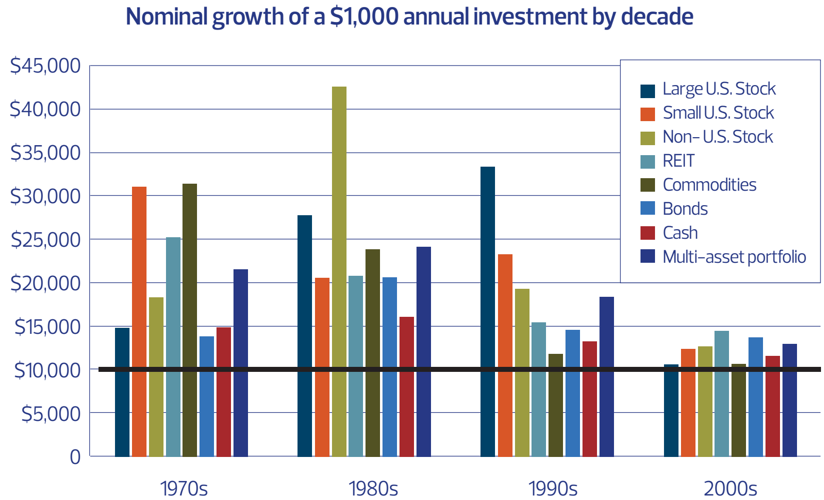
But once again, the boring multi-asset portfolio turned in a stellar performance. It outperformed small U.S. stocks, real estate, domestic bonds and cash.

• **The 1990s.** During the 1990s, the spotlight turned to large U.S. equities. In second place were small U.S. stocks, followed by non-U.S. stocks. The multi-asset portfolio was solidly in fourth position, ahead of real estate, commodities, U.S. bonds and cash.

• **The 2000s.** With the most recent decade of the 2000s finally in the rearview mirror, we find that every asset class struggled to finish in the black—that is, to have an ending balance that exceeded the $10,000 total investment. The winner was real estate, buoyed by great performance early in the decade, fol-

WINNERS BY DECADE

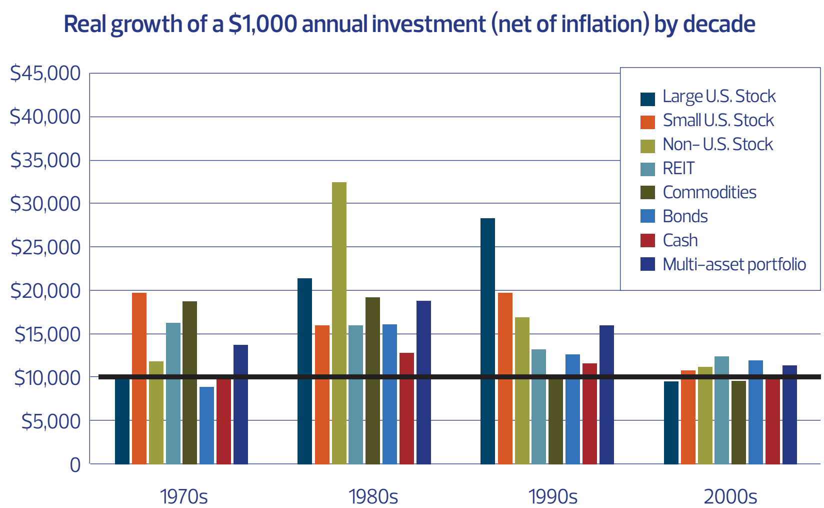
When comparing the performance of seven asset classes over the past 40 years, each decade produced a different frontrunner.



Source: Morningstar raw data, calculations by author

REAL WINNERS BY DECADE

Taking inflation into account, the multi-asset portfolio was a model of consistency through boom and bust.



Source: Morningstar raw data, calculations by author lowed by U.S. bonds. Coming in third was the multi-asset portfolio.

These four decades reveal a clear pattern—broad diversification in portfolio design produces performance that is more consistent. By creating an equally weighted portfolio, you won't hit the home run (such as being fully invested in small stock and commodities in the 1970s, non-U.S. stock in the 1980s and large U.S. stock in the 1990s), but you will achieve the type of solid performance that ends up winning the batting title.

ADJUSTING FOR INFLATION

Now the real test—an examination of decade-by-decade performance after adjusting for Consumer Price Index (CPI)-based inflation (see "Real Winners by Decade," on page 105). Under these more demanding conditions—also known as real life—we observe that inflation was a formidable opponent in the 1970s. Indeed, during that decade, the 10-year annualized rate of inflation as measured by the CPI was 7.4%.

• **The 1970s.** During this decade, three of the seven individual asset classes failed to grow the $1,000 per year annuity investment beyond the amount invested (as noted by the $10,000 horizontal black line). Large U.S. stocks, U.S. bonds and cash finished with account balances under $10,000. By comparison, a 100% investment in U.S. small stocks finished with an ending balance of nearly $20,000.

The multi-asset portfolio chugged along during the decade, ending with a final balance of $13,332. Of course, it would have been impossible to have known at the start of 1970 that U.S. small stocks would finish the decade as the winning asset class.

• **The 1980s.** In this decade, inflation cooled off to an annualized rate of just over 5%. As a result, real returns of the various assets all produced a net after-inflation gain. The multi-asset portfolio placed solidly among the leading asset classes during the 1980s.

• **The 1990s.** Inflation averaged 2.9% per year in this decade, allowing all the individual asset classes to produce positive growth in the $1,000 annual investments. The multi-asset portfolio was again a solid performer during the 1990s in terms of real, after-inflation return.

• **The 2000s.** During this ugly decade, nominal growth among the seven different asset classes was minimal. None of them was able to reach an ending account balance of $15,000 by the end of the decade. In each of the three previous decades, at least one of the seven asset classes had an ending account balance in excess of $30,000.

To say the least, the 10-year period from Jan. 1, 2000, to Dec. 31, 2009, was a humbling experience—even for investors who were dollar cost averaging (that is, making annual investments of $1,000) all the way through the decade. Once again, the multi-asset portfolio turned in a solid performance, at least in relative terms.

The silver lining of the past decade (2000-2009) was low inflation as measured by the CPI—coming in at an annualized rate of 2.6%. Even still, two of the individual assets (large U.S. stocks and commodities) finished the decade with cumulative balances under $10,000, or "under water." Cash was barely positive with an ending real balance of $10,017. The multi-asset portfolio wasn't a rock star, but it did finish the decade with a positive net gain (ending balance of $11,110).

So what have we learned from analyzing four decades of asset class returns? Just this: An equally weighted, multi-asset approach to building investment portfolios is the model of consistency through booms and busts.

A multi-asset portfolio represents the essence of a well-designed investment plan. At the very least, an investment portfolio should have a multi-asset core.

Beyond that, it's up to the investor and advisor to appropriately overlay individualized investment assets that meet the specific needs of each client. It's the old "core and explore" concept—but with a clear message that the "core" should be broadly diversified.

Here's the real beauty: Financial advisors don't have to preach the benefits of consistency; older clients already get it. FP

During the last decade, no asset class was able to grow a $1,000 per year annuity investment to $15,000. The silver lining was low inflation.

Craig L. Israelsen, PhD, is an associate professor at Brigham Young University, designer of the 7Twelve Portfolio (www.7TwelvePortfolio.com) and author of *7Twelve: A Diversified Investment Portfolio with a Plan*.