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Does Patience Really Pay Off?

Clients who are properly diversified for the long term should not be concerned when the markets make scary short-term moves.

BY CRAIG L. ISRAELSEN

MANY ADVISORS MAY HAVE KICKED OFF 2016 BY fielding communications from panicked clients, as equities plunged into a sea of red. But does the recent underperformance of equities, particularly of large-cap U.S. stocks, mean catastrophe for these clients' portfolios?

Not if they are diversified – and patient.

Now that 2016 is in full swing, it's time to dive into a performance review of key market indexes, along with a diversified 12-index portfolio model. The indexes in this analysis represent the following broad asset classes: U.S. equities, non-U.S. equities, real estate, resources/commodities, U.S. bonds, non-U.S. bonds and cash.

Shown in the graphic "15-Year Performance" are the annual total returns of 12 key indexes and a 12-index equally weighted portfolio model over the past 15 years (all performance data as of 12/31/2015). Also shown is the 15-year annualized return (which is a geometric mean), the 15-year standard deviation of annual returns and the worst one-year return.

STARTING WITH A THUD

The S&P 500 started out this particular 15-year period with a thud. In 2001, it lost 11.89%, then plummeted 22.1% in 2002. Patient investors who rode through the pain were rewarded with positive returns from 2003 to 2007 (28.68%, 10.88%, 4.91%, 15.79% and 5.49%).

Then, of course, the financial world collapsed in 2008. The S&P 500 fell 37% that year.

Once again, following the crash, patient investors who stayed the course were rewarded with seven years of positive returns (2009-2015). In some of those years, the gains were modest (2.11% in 2011 and 1.38% in 2015), but some years saw stunning performances (26.46% in 2009 and 32.39% in 2013).

Over this particular timespan, the S&P 500 produced a 15-year average annualized return of 5.0%, below its 90-year average annualized return of 10.02% (from 1926 to 2015).



The table also includes the returns for the S&P Midcap 400 Index, the S&P 600 Small Cap Index, MSCI EAFE Index, MSCI Emerging Markets Index, Dow Jones U.S. Select REIT Index, S&P North American Natural Resources Sector Index, Deutsche Bank Liquid Commodity-Optimum Yield Index, Barclays U.S. Aggregate Bond Index, Barclays U.S. TIPS Index, Barclays Global Treasury ex-U.S. Index and 3-month U.S. Treasury Bills (which represent the return of "cash").

REAL ESTATE WINS

It's worth noting that the S&P 500 was not the highest performer in any of the past 15 years, despite the fact that it is probably the most observed and mimicked index in the world. Real estate has been the best performer in five of the 15 years, fully one-third of the time.

The emerging markets index was the best performer in four separate years, and commodities had the best return twice (2002 and 2004). Small-cap U.S. stock, natural resources, TIPS and non-U.S. bonds all had one winning year over the past 15. Natural resources sustained heavy losses in 2014 and 2015, and commodities (as measured by the

15-YEAR PERFORMANCE

12 Indexes and a 12-Index Model

Year	S&P 500 TR	S&P Mid Cap 400 TR	S&P 600 Small Cap TR	MSCI EAFE NR USD	MSCI EM TR USD	Dow Jones U.S. Select REIT TR	S&P North American Natural Resources Sector TR	db Liquid Commodity - Optimum Yield TR	Barclays U.S. Aggregate Bond TR	Barclays U.S. TIPS TR	Barclays Global Treasury ex-U.S. TR	US Treasury Bills 3 Months TR	12-Index Model
2001	-11.89%	-0.60%	6.54%	-21.44%	-2.37%	12.35%	-15.59%	-7.91%	8.44%	7.90%	-3.95%	3.43%	-2.09%
2002	-22.10%	-14.51%	-14.63%	-15.94%	-6.00%	3.58%	-12.99%	25.58%	10.25%	16.57%	21.89%	160%	-0.56%
2003	28.68%	35.62%	38.79%	38.59%	56.28%	36.18%	34.40%	26.87%	4.10%	8.40%	18.21%	1.01%	27.26%
2004	10.88%	16.48%	22.65%	20.25%	25.95%	33.16%	24.59%	38.26%	4.34%	8.46%	12.06%	1.37%	18.20%
2005	4.91%	12.56%	7.68%	13.54%	34.54%	13.82%	36.61%	31.93%	2.43%	2.84%	-8.79%	3.13%	12.93%
2006	15.79%	10.32%	15.12%	26.34%	32.55%	35.97%	16.85%	16.98%	4.33%	0.41%	7.28%	4.71%	15.56%
2007	5.49%	7.98%	-0.30%	11.17%	39.82%	-17.55%	34.44%	32.63%	6.97%	11.64%	10.94%	4.38%	12.30%
2008	-37.00%	-36.23%	-31.07%	-43.38%	-53.18%	-39.20%	-42.55%	-30.94%	5.24%	-2.35%	9.43%	1.37%	-24.99%
2009	26.46%	37.38%	25.57%	31.78%	79.02%	28.46%	37.54%	16.15%	5.93%	11.41%	4.35%	0.15%	25.35%
2010	15.06%	26.64%	26.31%	7.75%	19.20%	28.07%	23.88%	12.37%	6.54%	6.31%	6.12%	0.14%	14.87%
2011	2.11%	-1.73%	1.02%	-12.14%	-18.17%	9.37%	-7.35%	-0.73%	7.84%	13.56%	5.24%	0.05%	-0.08%
2012	16.00%	17.88%	16.33%	17.32%	18.63%	17.12%	2.20%	1.12%	4.22%	6.98%	1.76%	0.09%	9.97%
2013	32.39%	33.50%	41.31%	22.78%	-2.27%	1.22%	16.49%	-9.01%	-2.02%	-8.60%	-4.88%	0.06%	10.08%
2014	13.69%	9.77%	5.76%	-4.90%	-1.82%	32.00%	-9.77%	-25.94%	5.97%	3.64%	-2.77%	0.03%	2.14%
2015	1.38%	-2.18%	-1.97%	-0.82%	-14.60%	4.48%	-24.28%	-29.64%	0.55%	-1.44%	-4.84%	0.05%	-6.11%
15-Year Annualized Return	5.00%	8.32%	8.92%	3.54%	8.87%	11.05%	4.54%	3.92%	4.97%	5.51%	4.45%	1.42%	6.82%
15-Year Annual Standard Deviation	18.9%	19.8%	19.3%	22.4%	32.9%	21.2%	25.3%	23.4%	3.1%	6.7%	8.9%	1.7%	13.3%
Worst 1-Year Return	-37.00%	-36.23%	-31.07%	-43.38%	-53.18%	-39.20%	-42.55%	-30.94%	-2.02%	-8.60%	-8.79%	0.03%	-24.99%

Source: Lipper, calculations by author

Deutsche Bank Commodity Optimum Yield Index) also suffered significant negative returns during the past three years (2013, 2014 and 2015).

BEATEN UP ASSET CLASSES

When asset classes get beat up (and they all do), it's tempting to forget the long-term picture and the achievements of the past, and react only to the current pain. This approach generally ends badly for clients.

For instance, the S&P 500 also had a negative return in the year 2000 (-9.10%), meaning it had three years in a row with heavy losses. Investors that bailed out and never came back lost out on the 8.90%

13-year annualized return that the S&P 500 generated between Jan. 1, 2003, and Dec. 31, 2015.

Similar examples could have been drawn from several of the other indexes, the point being that successful investing is not about good timing, but good behavior.

Pick a broadly diversified strategy and stay with it for the long term. Rebalance the portfolio because, when you do, you are actually selling high and buying low.

An example of a diversified strategy is illustrated in the far right column of the table: a 12-Index portfolio model. It's a strategy that combines all 12 of the indexes, equally weighted at 8.33% each, and annu-

ally rebalanced.

Several attributes of the 12-index portfolio model quickly stand out. First, it never once had the highest annual return.

Guess what? It never will. It's impossible. A diversified portfolio that contains multiple distinct asset classes will never outperform the best-performing single asset class within the portfolio.

And, conversely, it will not perform as badly as its worst-performing ingredient. Those are the basic ground rules of a diversified portfolio – it delivers middle of the road, steady returns. Will that be good enough?

THE 12-INDEX APPROACH

Over the past 15 years, a 12-index portfolio approach delivered an annualized return of 6.82%, which exceeded the 15-year performance of the S&P 500, the MSCI EAFE Index, the S&P Natural Resources Index, the Deutsche Bank Commodity Index, the Barclays Aggregate Bond Index, the Barclays TIPS Index, the Barclays Global Bond Index and U.S. 90-day Treasury Bills.

Plus, the 12-index model delivered a 6.82% annualized return while producing a 13.3% standard deviation of annual returns. By comparison, the S&P 500 had an 18.9% standard deviation.

The 12-index portfolio had a 182-basis-points-higher return than the S&P 500, with roughly 30% less volatility.

Clearly, real estate has been the standout performer among these 12 indexes over the past 15 years, by virtue of its 11.05% average annualized return. It produced a standard deviation of return of 21.2%, which was slightly higher than the S&P 500 and about 60% higher than the 12-index model. Is the extra volatility worth it? That is the challenging question that every client has to ask – and answer – for themselves.

In terms of volatility, emerging markets pegs the risk meter with a 15-year standard deviation of annual returns of 32.9%.

Emerging markets did, however, deliver an impressive 15-year annualized return of 8.87%. Once again, is that level of volatility worth it?

3 KEY OBSERVATIONS

1. The benefits of diversification manifest themselves over 10- to 15-year periods. Clients who are checking their portfolios every 15 minutes – or every 15 days, or even every 15 weeks – may not be good candidates for a diversified model.

A possible solution for the client who tends to be a diehard micromanager: Partition their portfolio into two segments. One segment is a broadly diversified model, where no micromanagement is ever allowed. Checking it annually and rebalancing are part of the ground rules for the client.

The other segment is composed of stocks or funds that the client is allowed (but not encouraged) to micromanage, within reasonable guidelines.

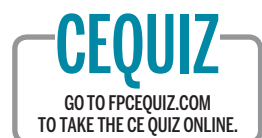
2. The 12-index model was never the winner in any given year. It never, ever will be. The client who diversifies a portfolio needs to be content with hitting singles and doubles – not homers.

3. This 12-index model does not favor any index, but employs equal weighting among the 12. As such, it is a purely strategic approach and is not attempting to market-time any particular asset class by over-weighting it.

However, viewed at the macro level, eight of the 12 indexes fall into the equity or diversifier asset class, and four of the indexes are fixed income, thus it represents a 65% growth/35% fixed-income overall asset allocation. This 65/35 allocation puts the 12-index model firmly in the camp of balanced funds, with their classic 60% stock/40% bond allocation.

The verdict: Over the 15-year period from 2001 to 2015, a diversified 12-index model fared well – for the patient investor. **FP**

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