EQUIUS ASSETCLASS[SM]
Modern asset class investing principles, research, and perspectives for long-term investors
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# Performance Expectations II

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I ended last month's article on performance expectations by asking the question, "What role do benchmarks play in this process?" I answered by stating that benchmarks are most useful to us at the *fund* level. And for performance evaluation purposes, that's true. But let's back up a bit.

Benchmarks are critical in deciding *which* long-term investing approach to use in the first place. We've eliminated consideration of active management as a reliable driver of expected returns because 80%+ of stock pickers and market timers can't beat the market.

This allows us to concentrate on what does drive returns: risk. Using benchmarks for asset classes that are described by different levels of risk and expected return is the first step along the path to long-term investing success.

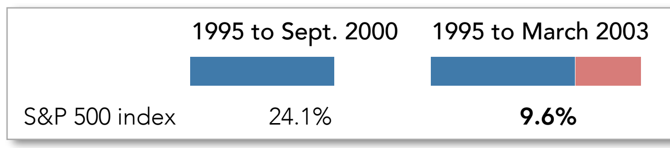
When *rational* investors make an investment decision, their *expected return* is directly related to the *perceived risk* of the investment. Naturally, these investors expect a higher return if they are taking on greater risk, and vice versa. Why would anyone take on high risk for a low relative return?

Is the *market* (the aggregate of all investors' buy/hold/sell decisions) always rational? Was it rational, for example, that large growth stock prices in the late 1990s (and today) were driven up to the point where they reflected low risk and low future returns? Most people would say absolutely not! But that's only because they have the benefit of hindsight.

Were most investors then (as now) engaging in high-risk speculation and expecting the 25%+ returns on those large, high-priced technology stocks to last forever? Or did they believe that we had entered into a new era similar to the industrial revolution and simply wanted to be invested with the companies best positioned to profit from this major economic trend?

I would argue it was the latter. Only irrational investors expected those very high returns to continue indefinitely. Some of them learned from the market's lesson over the subsequent two and a half years. But far too many compounded their ignorance by bailing out of the market after losing their shirt and missing the inevitable recovery. Some of those people are making the same mistake today. Rational investors (knowing the folly of market timing) stayed the course and received risk-appropriate returns.

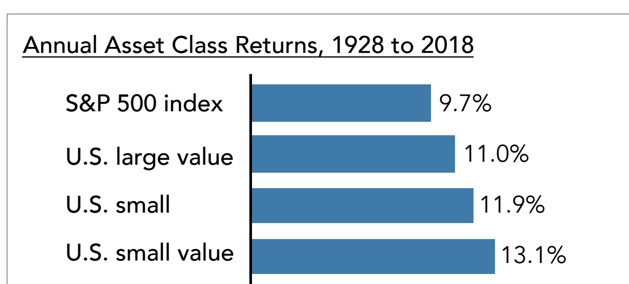
The evidence? The S&P 500 index, a benchmark dominated by large growth companies, produced an annual return of 9.8% over the 67 years 1928-1994. Is that a reasonable *expected* return for U.S. stocks, or is it the 24% per year the market gained from January 1995 to September 2000? The market answered that question over another two and a half years.




Now let's dig deeper into risk. There should be little dispute that smaller companies in various industries are riskier than larger companies. Investors in those smaller companies should reasonably expect a higher return for taking on this greater risk.

It's also reasonable to assume that stocks in the same industry that are priced lower than the others relative to their earnings, cash flow, and other metrics are priced that way because investors perceive greater risk associated with those companies. Why, for example, would you pay the same relative price for Kmart as you would for Walmart?

Have benchmark returns met these expectations over time? Let's see:




*Please see benchmark descriptions in article endnotes.*

From this data we can derive a core set of risk-based asset classes. The best academic research (Fama and French, et al.) supports these as reasonable dimensions on which to build long-term portfolios. The same relationships exist for non-U.S. developed and developing markets, and benchmarks for these dimensions have been created as well, allowing us to develop globally diversified portfolios for our clients. There is additional research supporting real estate—using a REIT benchmark—as an additional asset class.

On the fixed-income side, for those investors whose needs and risk tolerance require a balanced portfolio, we have bond benchmarks based on quality and term (length of maturity).

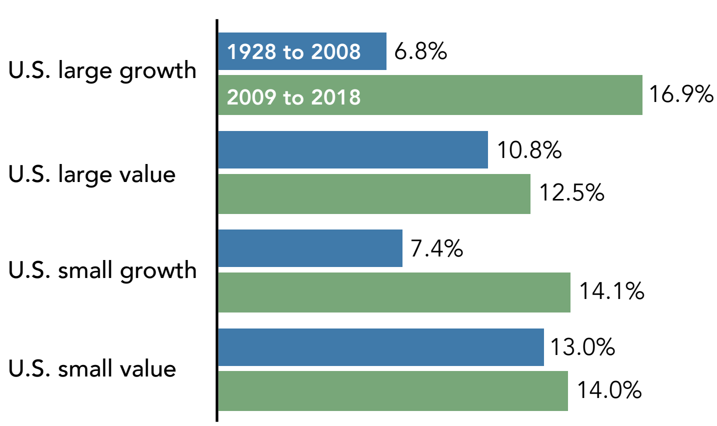
So, now going full circle, how do we use these benchmarks to evaluate your performance?

It's safe to assume that if you're reading this as an Equius client, you have considered and accepted the rationale behind our asset class, risk-based portfolio structure for your investing life cycle (and most likely for that of future generations of your family and/or philanthropic interests) based on these benchmarks. So the most practical use of benchmarks *from your perspective* is to consider them in the *short term* and either learn something new or reinforce core rational beliefs and expectations.

In *Understanding Investment Performance*, Gerard O'Reilly, Dimensional's co-CEO and chief investment officer, concludes "understanding volatility is key to becoming a [successful] long-term investor." Studying short-term performance *helps you set rational volatility expectations*. With the right expectations, you will experience fewer surprises—resulting in an easier time staying disciplined when the asset class planets are not currently aligned (i.e., they don't match the expected risk/return relationship shown in the chart above).

In that spirit, let's look at a perspective on the last 10 years compared with the previous 81 years. The blue bars in the following chart are good approximations of the expected returns for those asset classes.

Annual Asset Class Returns, 81 years versus past 10 years

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The risk/return planets were aligned over the long term, 1928 to 2008. Small beat large, value beat growth. But for the past 10 years, we've experienced something very different. While large and small value stocks have tracked pretty closely (but higher than) than historical averages, large and small growth stock returns are "off the chart." They are 148% and 91% higher for this period than their long-term averages, respectively. In contrast, large and small value stocks are 16% and 8% higher, respectively.

Do you believe these deviations from historical and theoretical expectations are sustainable? Do you believe the timing of these deviations is predictable? Do you believe now is the time to shift from large and small value stocks to large and small growth stocks? These are the questions investors and advisors should ask themselves. In almost all situations, the answer is no.

We are experiencing a similar deviation from long-term averages in the non-U.S. markets, and investors in global portfolios should ask themselves the same questions. From 1970 (inception of the MSCI EAFE index) to 2008, the S&P 500 and EAFE indexes returned 9.5% and 9.7% annually, respectively. But since 2009, the S&P 500 annual return is 54% higher (13.1% vs. 9.5%) while the EAFE return is 30% *lower* (6.8% vs. 9.7%).

As I mentioned at the start of this article, we monitor how the funds we use for client portfolios compare to appropriate benchmarks. Dimensional recently published a couple of reports showing some of these comparisons.* Key takeaway: While only 15% of equity and fixed-income funds that were around at the start of 1999 beat their Morningstar category index over the following 20-year period, 85% of Dimensional equity and fixed-income funds outperformed their benchmarks.

This is the essence of our approach: build portfolios around core asset classes using the best tools available with an overlay of perspective and discipline to deal with short-term volatility. Not surprisingly, it's worked well for our clients for over 26 years.

*Description of benchmarks: "U.S. large value" is the Dimensional US. Large Cap Value Index, "U.S. small" is the Dimensional US Small Cap Index, "U.S. small value" is the Dimensional US Small Cap Value Index, "U.S. large growth" is the Dimensional US Large Cap High-Price-to-Book Index, and "U.S. small growth" is the Dimensional US Small Cap High-Price-to-Book Index. S&P 500 courtesy of Standard & Poor's.*

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