

## It's Important to Stay Patient

### SYNOPSIS

- Conservative investors are losing their patience and growing increasingly frustrated paying for active management that seems to barely exceed the return of benchmarks.
- The desire to go to cash or simply buy index funds may sound appealing, but the reality is that these are not viable options for the overwhelming majority of investors.
- A long-term investment horizon that spans for more than a few years, combined with the powers of compounding, can still handsomely reward those who are patient.

### LOW RETURNS LATELY

As we wind down yet another dramatic year in financial markets, conservative investors are becoming increasingly frustrated. This cohort has been told to be patient, but attractive returns continue to elude them time and time again. Instead, they realize annual returns that barely break even after fees and inflation are subtracted.

The table below shows the performance of various allocations to U.S. stocks and bonds. Starting on the far left column, the percentage on the left represents the S&P 500, and the one to the right is the Barclays Agg (the de facto fixed income index).

Clearly, well-diversified and conservative portfolios have not impressed over the past few years. For example, a portfolio consisting of 40% stocks and 60% bonds has returned a mere 1.85% over the last 12 months.

*Allow compounding and a slowly growing economy to do its job, which will require continued patience by investors for years to come.*

The results look even less appealing when compared against a globally diversified portfolio of stocks. Below shows various combinations of the MSCI World equity index (left) and the Barclays U.S. Agg (right).

| Balanced World Indexes | 1 mo  | 3 mo | 1 yr  | 3 yr | 2008   |
|------------------------|-------|------|-------|------|--------|
| 20% - 80%              | -0.31 | 1.12 | 0.76  | 3.43 | -4.25  |
| 40% - 60%              | -0.36 | 1.77 | 0.48  | 5.34 | -13.20 |
| 60% - 40%              | -0.41 | 2.37 | 0.14  | 7.24 | -20.10 |
| 80% - 20%              | -0.45 | 2.92 | -0.26 | 9.11 | -29.56 |

*Data as of November 30, 2015*

Why has it been so hard for a conservative investor to achieve the results that seemed so readily available just a few years ago? The answer lies in the Fed's decision to keep interest rates artificially low for so long. Since investors cannot earn a return in CDs, money market funds, and government bonds, riskier bonds and stocks have been the only source of income.

This phenomenon has forced investors to make a choice. Either they (1) stomach more volatility to collect the income in these riskier assets, (2)

| Balanced Indexes | 1 mo  | 3 mo | 1 yr | 3 yr  | 2008   |
|------------------|-------|------|------|-------|--------|
| 20% - 80%        | -0.14 | 1.62 | 1.44 | 5.46  | -4.25  |
| 40% - 60%        | -0.03 | 2.79 | 1.85 | 7.78  | -13.20 |
| 60% - 40%        | 0.07  | 3.77 | 2.03 | 10.03 | -20.10 |
| 80% - 20%        | 0.19  | 5.01 | 2.50 | 12.25 | -29.56 |

*Data as of November 30, 2015*



earn next to no return in the traditional low volatile assets, or (3) ignore diversification and over-allocate to high growth stocks.

**NOTE:** *Although it may sound appealing to have matched the returns in the S&P in 2013 (+31%) and 2014 (+14%), a portfolio only invested in this index poses tremendous risk to an investor. The S&P 500 is a small subset of stocks for a single region, and diversification demands broader exposure to financial assets and markets.*

Simply put, conservative investors have every right to be frustrated, but they also must have realistic expectations going forward. The current low return world, one that has not existed in over 90 years, will most likely persist for quite a while longer.

## WHAT'S AN INVESTOR TO DO?

After seeing such tepid returns in the tables above, two questions are likely on the minds of investors:

1. If returns are unimpressive and interest rates are going to start rising soon, why not just go to cash, wait out this low return environment, and get back in at a later date?
2. Why should I pay for active management in years when expected returns are so low? Why not just buy index funds and pay next to no fees?

These are two very good questions, so let's first explain why moving to cash is not a viable option. Cash investments have returned less than 1% for over six years, and they will most likely continue to lose to inflation for the next decade (possibly even longer).

The reason for this less than sanguine forecast lies with not the timing of the first interest rate hike, which has been the focus of the pundits, but rather the slow pace the Fed will allow rates to rise over the coming years. For example, the last time interest rates were this low, it took 16 years for yields on cash investments to exceed 1% and over 34 years to reach 3.7%!

Hence, an over-allocation to cash will do nothing more for an investor than allow him/her to "lose money safely" for possibly decades to come.

Furthermore, the desire to trade in and out of markets to avoid short-term weakness in asset prices is akin to gambling. Emotions move markets in the short-term, and crystal balls are hard to come by in this business. Staying invested will, at the very least, generate income in conservative portfolios over time that far exceeds cash.

The second question depends on the profile of the investor, and many can and should consider more passive investment strategies. If an investor has 30+ year before retiring, there's nothing wrong with owning low-cost index funds and not paying for active management.

However, before you make up your mind, be sure to take a long hard look at the right column in both tables above and ask yourself a very simple question. Are you able to tolerate a drawdown of that magnitude in a single year? For example, are you comfortable being down 20%+ in a portfolio consisting of 60% in an S&P 500 index fund and 40% in a fixed income index fund?

If the answer is "no," then you need to invest with an active manager who is not only paid to deliver performance but also to protect the downside.

If the U.S. economy is declining, an S&P 500 index fund manager is not going to eliminate an equity allocation entirely and sit in cash for an extended time period. Only active managers with the flexibility to alter their asset allocation can service those investors who seek this protection.

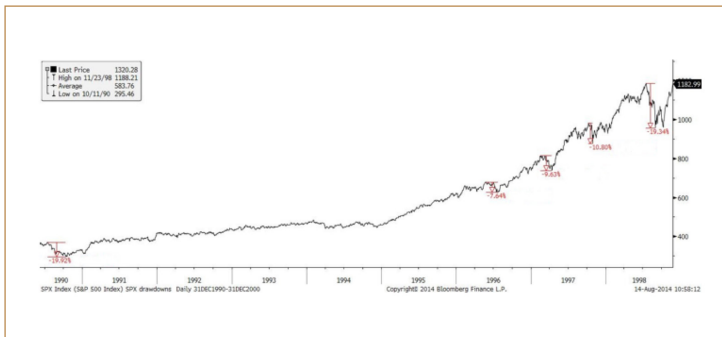
## IMPLICATIONS FOR INVESTORS

We have not seen an investment climate this frustrating since the Great Depression. To make matters worse, interest rates appear to be rising in the coming weeks/months, and the implications of

the first rate hike in almost a decade will likely cause periodic volatility.

Hence, conservative investors should manage their expectations by assuming returns will likely stay lower for longer, but that's not to say that we can't make attractive returns over time.

Case in point: The chart below shows the performance of the S&P 500 during the 1990s.



Although the back end of this chart is the most impressive portion, I want to focus primarily on the first five years. Take a look at the progression of the index on a year-by-year basis. Each year prior to 1995, on it's own, looks pretty boring. The index looks as if it barely moved in years such as 1992 and 1993.

Now, look closely at the path from 1990 to early 1995, and you will see a very strong, albeit slow,

return over this five-year period. The reason for such a discrepancy between annual returns and the five-year return has to do with the power of “compounding,” which transformed boring annual returns into an impressive long-term return.

I highlighted this time period because it's the last time we experienced a “secular” bull market, which is an extended periods of strong investment returns. This concept is most likely unfamiliar to most, given we haven't seen one since the 1990s, or 25 years ago.

Secular bull markets are ironic in the sense that you never really feel like you are in one during the rise. Typically, skeptics use the low annual returns to point to a slowing economy, and fear mongers use it as a core component to their “end of the world” thesis. However, when you look back at these periods, they represent some of the best times to accumulate real wealth.

***The bottom line*** is that I continue to believe that we remain in a bull market for years to come, and investors will miss it if they are too focused on annual returns instead of the bigger picture. Allow compounding and a slowly growing economy to do its job, which will require continued patience by investors for years to come.

Sincerely,



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