Lost—and Found

Given the proper asset allocation, the Lost Decade was not as bad as it could have been. By Craig L. Israelsen

The 10-year period from 2000-2009 has been referred to as the Lost Decade. During these years, the 10-year average annualized return of the U.S. equity market (as measured by the S&P 500) was -1% (-0.95% to be exact). A $10,000 investment on Jan. 1, 2000, was worth $9,089 on Dec. 31, 2009.

To put this performance into perspective, there have been 75 consecutive 10-year periods (rolling decades) since 1926. The average 10-year average annualized return for the S&P 500 over those 75 periods was 10.8%. (Raw performance data obtained from Morningstar Principia.)

Still, the Lost Decade was only lost if you were 100% invested in large-cap U.S. stocks. In fact, the last 10-year period was one of only four such periods since 1926 in which the S&P 500 produced a negative 10-year average annual return. The other three periods were 1929-1938 (-0.9%); 1930-1939 (-0.1%); and 1999-2008 (-1.4%).

On the other hand, if you were hunkered down in an all-bond portfolio between 2000 and 2009, you had a better-than-average experience. Likewise, if you had a marginally diversified portfolio (such as a blend of 60% large U.S. stock and 40% bonds), you emerged at the end of 2009 with a modest gain. In retrospect, the Lost Decade was actually a referendum on the importance of asset allocation and diversification.

NOT EITHER OR

Investors could have invested in a 100% bond portfolio during the Lost Decade. If they had, they wouldn't feel lost. In fact, the 10-year annualized return for a portfolio consisting entirely of U.S. bonds (using the Barclay's Capital Aggregate Bond Index) was 6.3% between 2000 and 2009. The average 10-year rolling return over the 75 10-year rolling periods since 1926 was 5.6%.

"The Big Dip," on page 179, shows the rolling 10-year returns for U.S. stock and bonds since 1926; the first date shown is 1935, which represents the first 10-year rolling period from 1926-1935. Note that the rolling 10-year return of bonds was under 5% for the first 39 rolling 10-year periods (from 1926 to 1973). In fact, the average U.S. bond return of the first 39 10-year rolling periods was 3%. There were 11 consecutive 10-year periods where the annualized return was below 2% during the 1940s and 1950s.

More recently, the performance of U.S. bonds has dramatically improved. The average return of the most recent 36 10-year rolling periods has been 8.4%.

The graph also shows the rolling 10-year returns of a 60/40 portfolio. As you would expect, this portfolio

THE BIG DIP

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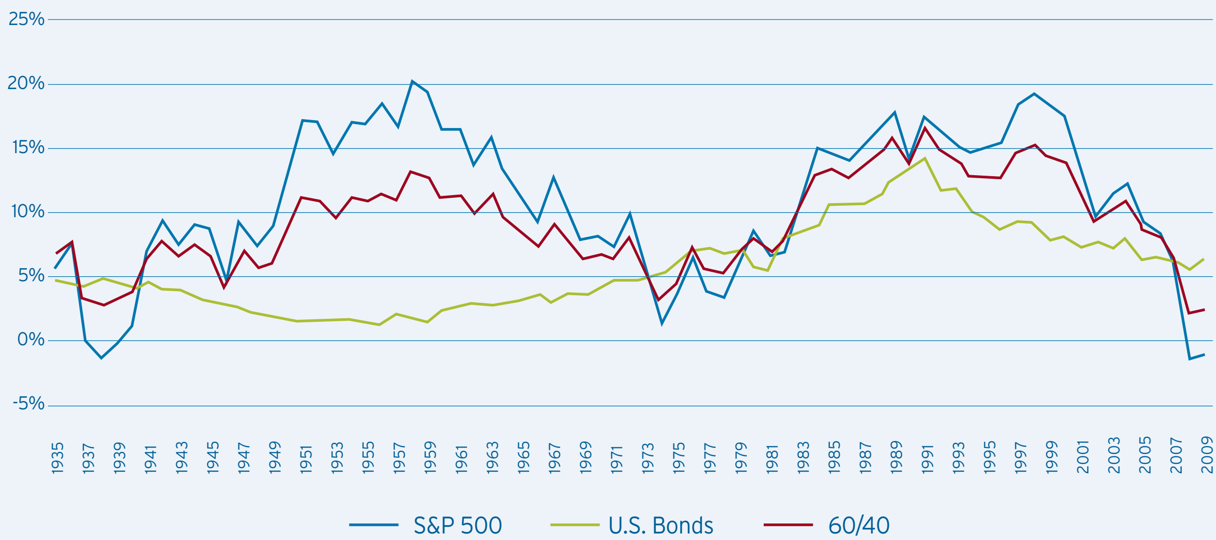


Source:: Author, using Morningstar data

BIGGER, NOT BETTER

For the most part, the biggest mutual funds became casualties of the Lost Decade.

10 Largest Mutual Funds at the Start of 2000	10-Year Annualized Return from 2000-2009
Vanguard Windsor II Investor	4.16%
Fidelity Contrafund	3.18%
American Funds Washington Mutual A	2.81%
American Funds Investment Company of America	2.50%
Vanguard Institutional Index	-0.91%
Vanguard 500 Index Investor	-1.03%
Fidelity Magellan	-2.27%
American Century Ultra Inv	-3.58%
Janus A	-3.92%
Fidelity Growth & Income	-4.09%

Source: Author, using Morningstar data

generates returns between the return of an all-stock portfolio and an all-bond portfolio. The average 10-year annualized return for a 60/40 portfolio over all 75 periods was 9.1%. During the 10 years from 2000 to 2009, a 60/40 portfolio had an annualized return of 2.6%—not up to par historically, but not necessarily a Lost Decade. The 60/40 portfolio was rebalanced annually.

WINNERS AND LOSERS

"Bigger, Not Better," at left, shows the 10 largest mutual funds (in terms of net assets) at the start of 2000. It also shows their 10-year annualized return from 2000 to 2009.

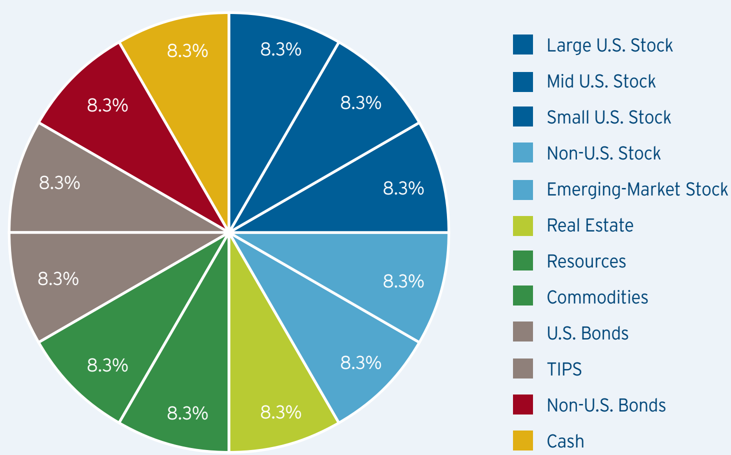
The biggest mutual funds produced a mixed set of results in the Lost Decade. Four of the funds had a positive 10-year annualized return, yet only three of them beat a simplistic two-asset 60% stock/40% bond index portfolio. For the most part, the titans were casualties of the Lost Decade.

In general, however, stock mutual funds were not entirely lost during

NO LOST DECADE HERE

A more broadly diversified and annually rebalanced 12-asset portfolio generated a 10-year annualized return of 7.8%, three times higher than a simple 60/40 portfolio.

Multi-Asset Model - 7Twelve Portfolio



10-Year Annualized Return= 7.8% (2000-2009)

Source: Author, using Morningstar data

the past decade. There were 1,825 U.S. equity funds that survived the entire 10-year period from 2000 to 2009. The average 10-year return of these funds was 2.2%, and 68.5% of the 1,825 funds had a positive 10-year annualized return.

Admittedly, these are the survivors. We can assume that the majority of mutual funds that failed to survive the entire 10-year period would have had a return well below the average.

DIVERSIFICATION DESIRE

Inasmuch as most investors can and should diversify, the most relevant question is how a well-diversified portfolio performed during the Lost Decade. A multi-asset model known as the 7Twelve portfolio will represent a broadly diversified portfolio (see "No Lost Decade Here," above).

Throughout the Lost Decade, a multi-asset portfolio consisting of exchange-traded funds, rebalanced back to equal one-twelfth allocations annually, produced a 10-year annualized return of 7.8%. (If the multi-asset portfolio was rebalanced monthly, the 10-year annualized return fell slightly to 7.5%.)

References to a Lost Decade are really references to poor asset allocation. The S&P 500 is a one-asset index—it contains only large U.S. companies. As a result, during a tough equity decade it failed to produce a positive return.

Funds that mimic the S&P 500 are perfectly suitable portfolio ingredients, yet they do not represent a diversified portfolio by themselves. Five hundred similar holdings do not create broad diversification. They may create holdings depth, but portfolios need asset breadth to be diversified.

Portfolios need more than one asset class to achieve genuine diversification. As shown, even a simple two asset 60/40 portfolio generated a positive return of 2.6% during one of the most dismal equity markets since the late 1930s.

A more broadly diversified and annually rebalanced 12-asset portfolio generated a 10-year annualized return of 7.8%, which was three times higher than a simple 60/40 portfolio returned. In short, the simple antidote for any Lost Decade is genuine diversification.

AT THE CORE

Simply put, every investment portfolio should have a diversified core component. This multi-asset core will be the same for every client, so financial advisors should not be wasting their time designing different core portfolios.

Rather than designing every portfolio from the ground up, advisors should determine how much of the multi-asset diversified core component to use and what type of "explore" assets to add to the core to best meet each client's unique needs. Essentially, a portfolio's core should become a commoditized product that all advisors use uniformly.

Financial advisors add their considerable value by knowing which individualized "explore" assets will help clients realize their goals over their investing lifecycle. With this structure in place, the likelihood of losing a decade or two along the way is very small. FP

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.

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