Perspectives on 2009 and Beyond

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In April 2008 I started writing about the miserable stock markets of this first decade of the 21st century, suggesting that things might get worse. They did, then get better in 2009, but not enough to bring the decade into positive territory. We’ve just experienced the worst U.S. stock market decade in eight decades.

This commentary examines 2009 and the past decade in the context of the stock market’s long-term history. I discuss domestic and foreign stock markets.

U.S. Stock Market

The U.S. stock market, measured by the S&P 500, earned 26.5 percent in 2009, rebounding from a 37-percent loss in 2008. This recovery wasn’t enough to restore previous losses, so the decade ended with an average annualized loss on the S&P of 1 percent per year, well below the 84-year long-term average return of 9.8 percent per year. By contrast, bond performance for 2009 (4 percent) and the decade (7.4 percent) was in line with historical averages (6.1 percent), as was inflation (2.8 percent). Completing the picture, Treasury bills yielded 0.15 percent for 2009.

Of the eight calendar decades for which we have data (1930s, 1940s, …), the 2000s were the worst-performing but not the worst 10-year period ever. Figure 1 shows returns of the past eight calendar decades, as well as the best and worst 10-year periods ever. There have been worse times than the 2000s: the S&P lost 5 percent per year in the 10 years ending August 31, 1939 (shown in the graph); we just experienced the worst real (return net of inflation) 10-year loss in the period ending February 28, 2009 (not shown). Did you feel it? That decade brought real cumulative losses of 49 percent, or 6.5 percent per year. No wonder we feel poorer.

Figure 2 shows in red how individual years of the 2000s fared historically. In green are individual years of the previous decade, which was very good. Years such as 2008 have happened before but not very often; only 1931, 1937, and 1974 had real losses in excess of 30 percent. Note that only three of the past 10 years (2003, 2006, and 2009) were reasonably good. By contrast, see the green-colored 1990s.

Investors would have been better off in bonds or Treasury bills than in stocks. Do you think the next decade will be better or bring more of the same? Where can we invest and be safe? Foreign markets would have helped in the past decade—they returned more than 6 percent per year, though they, too, suffered 2008 losses.

The ride has been bumpy. The bubble burst during 2000–2002, then the stock market clawed back so investors had earned an average 3.5 percent per year return and were back even with inflation for the decade-to-date as of October 2007. Then the next 16 months took all of that back and more, with the S&P plummeting 55 percent from November 1, 2007, through February 28, 2009. Those 16 months were painful, stress-testing professional investment managers and investments that are supposed to be good defensive plays. Yes, we made up some ground in 2009, but we must remain guarded. Below we review various market segments and strategies to show what worked—and what didn’t—in 2009 and the decade. The bottom line: Everything worked in 2009 and only growth stocks failed for the decade. The real questions are all about the future; an understanding of the past should help.

The Year 2009

Every investment style had substantial gains in 2009. Smaller companies gained more than 40 percent, exceeding the 24-percent return for larger companies. Similarly, growth outperformed value, earning 37 percent versus 29 percent. The “stuff in the middle” that we call “core” surprised by underperforming both value and growth, a somewhat unusual occurrence.

Every sector had gains in aggregate, but it was certainly possible to lose money in several sectors. Figure 3 shows the range of portfolio opportuni-
ties available in each economic sector using the “portfolio opportunity distributions” (PODs) simulation approach, which creates portfolios at random by selecting from stocks in each sector. Figure 3 shows that information technology was the best-performing sector for the year, earning 65.74 percent, while finance was the worst-performing, earning 11.44 percent. Note the ranges of the floating bars.

Financials had lots of opportunities, i.e., a large spread in portfolio returns, while consumer discretionary was quite narrow. Note also how the S&P 500 performed in each sector (red dot), near median in most, but underperforming in energy, where smaller companies fared best. Note the sector weighting differences in the bottom of the graph. You can use this exhibit to dissect your own performance.

The S&P portfolio of 500 large companies underperformed the broad market of roughly 5,500 stocks in 2009, earning 26.5 percent versus the total market’s 31-percent return. Yes, the S&P is a managed portfolio; it’s just managed by committee. A closer look reveals the biggest, best, and worst stocks in the S&P during 2009 (table 1).

Moving outside the United States, it was possible to double your money. Foreign markets fared much better in 2009, earning 45 percent versus our 31 percent. Latin American stocks returned a sensational 108 percent and every country except Japan outperformed the United States, so some will say that diversification “worked” and vindicated portfolio theory, which was criticized previously when everything tanked at the same time. Nothing works all the time, and diversification doesn’t promise better performance, just greater stability of returns. It is indeed a world market, and owning more than just U.S. companies was beneficial in 2009.

The Decade of the 2000s

Based on our analysis, the average U.S. stock fund eked out a modest 0.1-percent per year gain during the past decade.

The good news, however, is that much of the pain was limited to growth sectors. This is awkward and delicate for growth stock managers and brings forth the difficult question about the superiority of value investing. As for value and core managers, they should have delivered positive returns for the decade, with smaller value stocks delivering double-digit returns. In other words, style effects are extremely pronounced and important for evaluating long-term performance. The old saw that value and growth perform about the same over the long run doesn’t apply to the past decade. Similarly, country results were wide-spread during the decade, with Japan losing 2.8 percent per year while Australia and New Zealand delivered 20-percent returns.

Figure 4 shows universes that are
created using the POD approach introduced above. They represent all of the possible portfolios that managers could have held when selecting stocks from the indicated markets. Use the charts to get an early and accurate ranking of your own portfolio—just plot your dot.

Conclusion

Returns were good in 2009, but it was one of only three good years in the past decade. U.S. investors broke even on average unless they were concentrated in growth stocks, where most losses occurred. Though growth outperformed value in 2009, it underperformed for the full decade, losing 8 percent per year while value stocks grew at 7 percent per year. This will make it difficult for growth stock managers to retain business because investors routinely confuse style with skill, and academics assert intrinsic superiority to value investing. Not that long ago, growth stock managers benefited from investors’ style-skill dyslexia as the growth bubble inflated. What goes around comes around. Do not confuse style with skill; custom benchmarks can help. Style rotation is a separate and distinct decision from the active-passive decision.

Diversifying internationally helped; every country except Japan outperformed the United States in the past decade. Some will say diversification worked because exposure to foreign markets improved returns, but that is not the promise of diversification. In theory, diversification improves the reward per unit of risk—it smooths out the ride.

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