

August 2018

This month, we expand on part of what we wrote in the April 2018 Paradigm. Conversations and meetings since that Paradigm suggest others would benefit from more detail, too.

From the April 2018 Paradigm

We will look at returns with a simplistic focus on stocks (S&P 500), bonds (Bloomberg Barclays U.S. Aggregate Index), and inflation (Consumer Price Index). For the 20-year period ending December 31, 2017, the average annual returns and the average annual inflation rate were:

Stocks	7.2%
Bonds	5.0%
Inflation	2.1%

Here are several important statistics for each of the above figures.

Stocks.

- 1. Returns of 7.2% per year, compounded for 20 years, means that \$1 grew to \$4.02. Adjusted for inflation of 2.1% per year, it means that \$1 grew to \$2.65.*
- 2. The S&P 500 declined by over 50% twice during this period.*
- 3. The 7.2% return was composed of 5.5% earnings P/E ratio.*

By providing more insights into each of the above statistics, we hope to increase your understanding of the concepts, thus, increasing your ability to maximize your long-term success.

Let's review and expand each of the three points made above.

Point #1. For a period that started later in the dot.com boom, the 20-year returns were very respectable. Also, 7% per year, compounded for 20 years, leads to big dollars. Yes, you would have spent part of the money if in retirement, but the compounding effect is still material.

Point #2. We wanted to impress upon people that the road to 7% per year for 20 years is filled with major pot-holes. We also wanted to prepare you psychologically for the high probability that such market downturns are likely to occur in the future.

As it turns out, mentioning a 50% market decline caused real concern among readers. Therefore, we want to materially expand our explanation regarding how major stock declines are not the same as major portfolio declines and how to handle such declines.

First, you own a diversified portfolio, not one that is 100% invested in stocks. During 2008, the S&P 500 was down 37% while the major U.S. bond index was up just over 5%. This meant a diversified portfolio (assume 60% stocks and 40% bonds) was down roughly 20%. The portfolio decline was painful, but not catastrophic.

Second, and much more important than many realize, is that diversified portfolios that adhered to their long-term plan recovered more quickly than all-stock portfolios. This is because by rebalancing your portfolio in early 2009 you had to buy stocks and sell bonds. This meant that a 60/40 portfolio recovered its 2008 losses by the end of 2010, while it took into 2012 for the riskier all-stock portfolio to fully recover.

Third, remember that to fund your lifestyle in retirement you are not forced to sell all your stocks during or after a market downturn. Given interest, dividends, and cash, you may need to sell less than 5% of your stocks in any given year. If you are living within your means, your lifestyle can withstand a few years of selling when prices appear low. On the flip side, in your lifetime you are likely to experience a few years of selling when prices appear high.

Point #3. Earnings growth was the major driver of returns over the past 20 years. Dividends accounted for roughly one-quarter of returns. Surprisingly, the change in valuation levels as expressed by the P/E ratio was a very slight negative to returns. This is in stark contrast to what occurred in the 1980 to 2000 period when expanding valuations added materially to returns. We were concerned that investors might still believe that increasing valuation levels were required for reasonable returns. They are not.

We appreciate your feedback during conversations and meetings. We hope that by using this feedback to elaborate on prior topics, you found this Paradigm useful.