Financial Alternatives Inc

integrated wealth management

Jim Freeman, CFP® / Chris Jaccard, CFP®, CFA **January 2016**

Review of 2015

2015 was a difficult year to make money. As you can see from the graph below, the S&P 500 (US Large Stocks) return was slightly positive while International and Emerging Market stock returns were negative - as were Commodity returns. High quality, Intermediate-term bonds were largely unchanged.

After years like this, it is tempting for investors to chase the investments with the best recent performance and flee the investments with the worst recent performance.

In this newsletter we will show why resisting this temptation and instead maintaining a patient, disciplined, and diversified strategy over the long-term is the best course of action.

We will also make a few comments about bear markets regarding their frequency and magnitude since the 1930s.

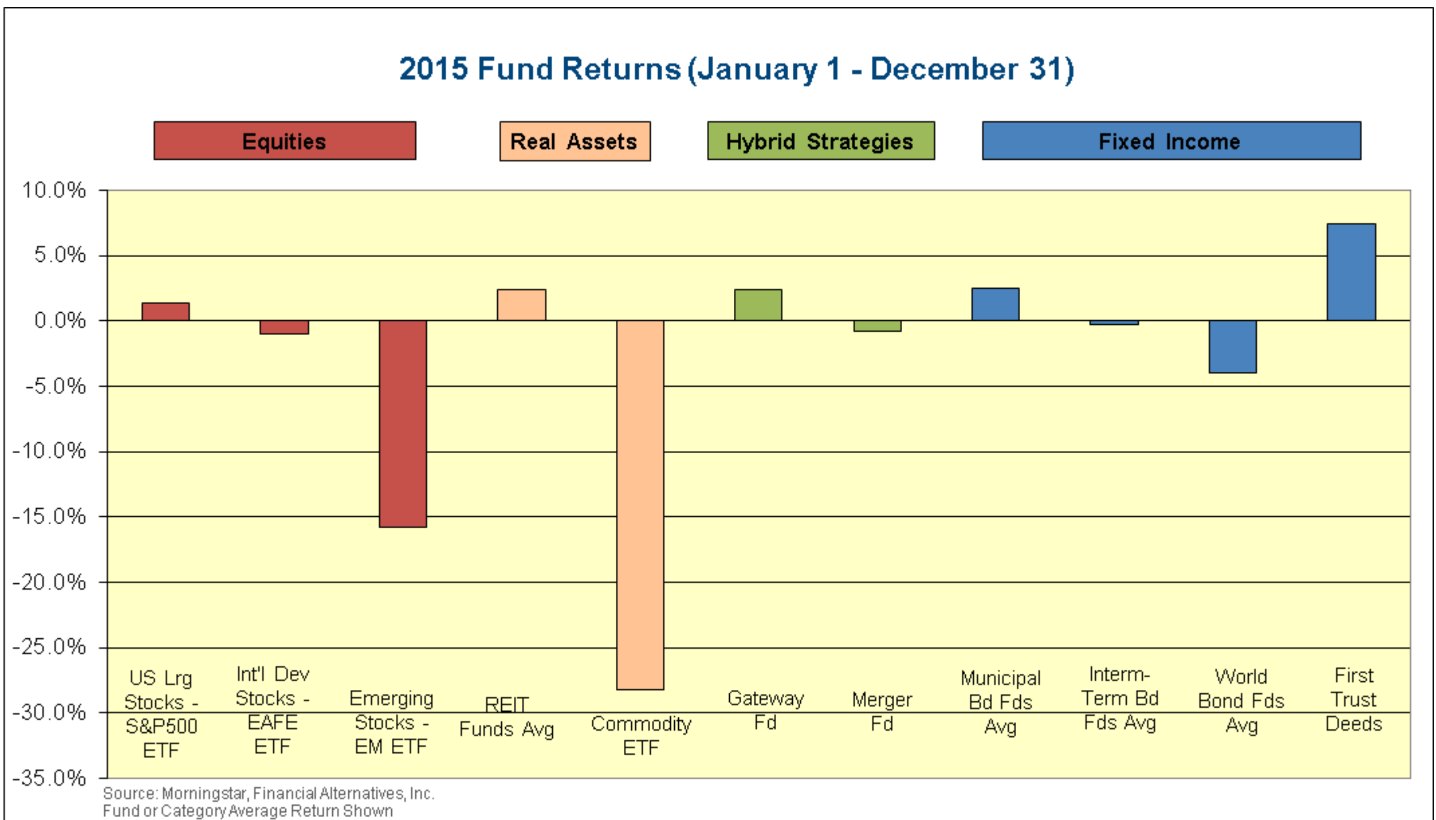
Executive Summary

- 2015 was a difficult year to make money.
- It is impossible to predict which asset class will outperform decade to decade.
- Different investments tend to cycle erratically between outperformance and underperformance on a regular basis.
- The temptation to chase the best performing and flee the worst performing investments is hard to resist.
- Market corrections occur on a regular basis and should not be feared.
- We advise remaining patient, disciplined and diversified.

The Case for Broad Diversification in Turbulent, Unpredictable Times

The 1972 – 2014 Performance Statistics table on the following page shows investment returns decade by decade for four different asset classes:

- US Stocks (S&P 500)
- International Stocks (MSCI EAFE Index)
- Real Estate (FTSE NAREIT Equity REITs Index)
- Commodity-Linked Securities (S&P GSCI 1972-1991, Bloomberg Commodity Index 1992-2014)



1972-2014 Performance Statistics

Entire Period

1972–2014	Portfolio A U.S. Stocks		Portfolio B Non-U.S. Stocks		Portfolio C Real Estate Securities		Portfolio D Commodity-Linked Securities		Portfolio ABCD Equal Allocation	
	Return[1]	Rank	Return[1]	Rank	Return[1]	Rank	Return[1]	Rank	Return[1]	Rank
Compound Annual Return	10.55	3	9.75	4	**12.22**	**1**	8.74	5	11.34	2
Future Value $1	$74.58		$54.54		**$142.48**		$36.67		$101.33	
Standard Deviation	17.80		22.36		18.27		21.69		**13.10**	
Sharpe Ratio	.37		.30		.45		.26		**.52**	

By Sub-Period

	Portfolio A U.S. Stocks		Portfolio B Non-U.S. Stocks		Portfolio C Real Estate Securities		Portfolio D Commodity-Linked Securities		Portfolio ABCD Equal Allocation	
	Return[1]	Rank	Return[1]	Rank	Return[1]	Rank	Return[1]	Rank	Return[1]	Rank
1970s[2]	5.11%	5	10.53%	4	11.08%	3	**22.06%**	**1**	14.17%	2
1980s	17.55%	2	**22.77%**	**1**	15.64%	4	10.67%	5	17.23%	3
1990s	**18.21%**	**1**	7.33%	4	9.14%	3	6.07%	5	11.11%	2
2000s	-0.95%	5	1.58%	4	**10.63%**	**1**	7.13%	2	5.20%	3
2010s[3]	15.45%	2	5.81%	4	**16.91%**	**1**	-5.53%	5	8.50%	3
# of below-average returns	2		4		1		3		**0**	

[1] Compound Annual Return
[2] 1972–1979
[3] 2010–2014
Best performance numbers are highlighted and in blue.

Source: Roger C. Gibson

As you can see, the top performing asset class (highlighted in blue) varied from decade to decade. It is impossible to predict which asset class will outperform in any given decade. For example, in the 1970s Commodities outperformed US stocks by over 15% per year and underperformed in the 1980s and 1990s; then, they once again outperformed in the 2000s and are underperforming so far in the 2010s. US stocks were the worst performing asset class in the 1970s, the best in the 1990s and then again the worst in the 2000s. REITs were never the top performing asset class in the 1970s, 80s and 90s but have been the top in the 2000s and the 2010s.

The column on the far right shows what the returns would have been in every decade if an investor had held a diversified portfolio of 25% in each of these four asset classes and rebalanced it back to 25% in each asset class at the end of every year. Returns for this portfolio are more consistent, eliminating the highs and lows of each individual asset class; and also it had much lower volatility as measured by the standard deviation figures shown on the chart.

Maintaining a diversified portfolio helps to smooth out returns over the decades. It requires discipline and patience not to chase the best performing asset classes year to year and decade to decade and not to flee the worst performing asset classes. Such patience and discipline has been rewarded over the long-term.

Cycles of Outperformance and Underperformance

From 2003 to 2008, a six year period, Emerging Markets stocks (as measured by the Vanguard Emerging Market Index fund) returned a total of 123.38% vs only 15% for US Stocks (as measured by the Vanguard S&P 500 Index fund). Then from 2009 to 2015, a seven year period, US Stocks returned 161.52% vs 79.29% for Emerging Market stocks.

These types of cycles are not uncommon. Because of this, the best strategy is to be disciplined in holding diversified asset classes of investments and rebalancing back to a predetermined allocation percentage on a regular basis.

Well-known investment author Burton Malkiel's recent WSJ Op Ed entitled, "Investing for 2016 in an Expensive Market" recaps our thoughts well in light of the recent underperformance in International Developed and Emerging Market stocks:

"Perhaps the most useful metric to assess valuations is the cyclically adjusted price earning multiple (CAPE). This is the ratio of today's market price to a measure of average earnings over recent economic cycles. CAPEs for broad stock-market indexes do not help in predicting returns one year ahead. But they do have a reasonably high correlation with average returns over, for example, the next five to 10

years".

Malkiel continues: "Today the CAPE stands at over 26 for the U.S. market, well above its long-run average. The CAPE is 20 for Japan, 15 for Europe and under 10 for emerging markets – below their long-run average".

Market Corrections

As we write this newsletter, stock markets around the world have seen volatility increase and we are currently experiencing a small correction. We would not be surprised to see the correction deepen since we have not had a more prolonged correction since 2011. Last year's correction was barely more than 10% and reversed itself very quickly.

Through out the years, we have emphasized with our clients that corrections are a normal part of stock market investing. The table to the right illustrates just how normal and regular they are. Since 1980, the S&P 500 has fallen by double digits eleven times or roughly once every three years.

During these corrections stocks fell on average 26%, and these periods lasted a total of just over 260 days (more than 8 months) before rebounding. If you look back to the 1930s, 40s, 50s, 60s and 70s, you see that there were double digit losses about every other year. These double digit losses and bear markets are the rule, not the exception.

The most important fact to remember is that every one of the above corrections eventually ended and the market went on to regain its value.

	Number of Double Digit Drawdowns	Average Losses
1930s	8	-38.8%
1940s	6	-20.6%
1950s	5	-15.6%
1960s	5	-21.1%
1970s	8	-17.6%
1980s	4	-23.0%
1990s	2	-19.6%
2000s	3	-40.2%
2010s	2	-17.7%

**Souce: Yardeni Research*

Summary

2015 was a difficult year for global investors. Stock markets around the world continue to be volatile and are currently experiencing a correction.

As the market corrections table illustrates, these drops occur on a regular basis and should be expected. Staying diversified and invested during falling markets is challenging but investors have been rewarded for their ability to do just that.

Please call us if you'd like to discuss your investments or any other aspect of your financial life in greater detail. We want to wish you all a Happy New Year.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

Financial Alternatives, Inc.

7734 Herschel Avenue Suite L
La Jolla, CA 92037
Phone: (858) 459-8289
Fax: (858) 459-8258

info@financialalternatives.com