Asset class investing continues to grow in popularity among serious investors, gaining ground in comparison to both traditional “active” strategies and a passive indexing approach. As a result, the volatility of asset classes in combination—rather than the volatility of each component of the portfolio—has taken on greater importance. Too often volatility is not considered in its proper context, costing long-term investors dearly over their investment time horizons. So let’s look at this issue in the context of each of these strategies.

Active Management Volatility

The first thing investors should understand about active management is that the future has little correlation with the past. Any strategy based almost completely on speculation (forecasts, predictions, and personal judgment) is inherently unpredictable in its outcome. So any measure of past volatility of returns is essentially useless.

Here are two perspectives to drive home the point. Let’s start with the highest-performing stock over the past 20 years: Amazon. Since its initial public offering, Amazon has appreciated 49,000%. In other words, a $10,000 investment has turned into $4.9 million. Now let’s consider the volatility of Amazon’s stock over that period. As Michael Batnick points out in his blog, “Irrelevant Investor,” Amazon stock “fell 15% in just three days 107 different times; it fell 6% in a single day 199 times; and it fell 95% from December 1999 to October 2001.” The following chart shows how far the stock fell from its high each calendar year.

How likely is it that any investor—professional or amateur—could have withstood that gut-wrenching volatility to realize the 36% annual return the Amazon stock achieved? Not very likely. And is there anyone who honestly believes he or she could have profitably timed moves in and out of the stock to avoid those declines while capturing the gains?

This level of volatility is common among high-performing stocks. What’s uncommon are high-performing stocks that persist over time.

Hendrik Bessembinder at Arizona State University found that the entire gain in the U.S. stock market since 1926 is attributable to the best-performing 4% of listed stocks. Clearly, this includes Amazon. What are the chances of owning and holding that meager 4% (or some subset) over an investor’s time horizon?

Yet this is exactly what active managers try to do every waking moment of their professional lives. Of course, they don’t realistically expect to buy and hold only the stocks that subsequently end up in that group 20 years later, but they strive to have a few of them in a 20 to 50 stock portfolio, right? How many investors—professional or amateur—do you know who actually bought and held Amazon (or any of those others in the 4%) for 20 years and beat the market return?

And how many Amazon-type stocks (those with exciting prospects for future growth) significantly underperformed or ended up as a total loss for their investors? I think you know the answer.

Indexing Volatility

Indexers and those who promote the strategy most vociferously (think Jack Bogle and Vanguard) suggest that investors should limit their acceptance of stock volatility to that of the total market only and avoid tilts to small cap or value stocks. Prof. Bessembinder’s research clearly argues against active management and for an indexed approach. But what about the volatility of the market as a whole? From November 2007 to February 2009, the S&P 500 fell a total of 51%!

Stock market declines like that are rare, but they do occur (as we remind clients constantly), and they’re huge compared with the downside risk and volatility of high-quality short-term bonds. Yet Bogle and others are perfectly comfortable suggesting that investors are well-rewarded for adding stock market risk to a bond portfolio. So why do they have such an aversion to adding small cap and value asset class risk?
Since 1926, stocks have outperformed Treasury bills 95% of the time over 15-year overlapping periods—the same percentage by which value stocks have outperformed growth stocks (it’s 82% for small outperforming large). Indexers act as if there has been no further progress in financial economics science since Eugene Fama’s work on market efficiency in the 1960s. Deniers?

Asset Class Investing Volatility

As Equius adopted a fully indexed strategy in 1992, we studied new research that Fama and his colleague Ken French published that same year. This research into the multiple dimensions of market returns showed that by accepting greater volatility on an asset class level, investors could expect higher returns from small cap and value stocks. We adopted our current asset class strategy in 1995 (after Dimensional Fund Advisors built U.S. and non-U.S. stock funds to efficiently exploit the Fama/French research) and our clients have benefitted very substantially as a result. Here’s what we observed then:

Index Returns: January 1928 to December 1994

<table>
<thead>
<tr>
<th>Index</th>
<th>Annual Return</th>
<th>Annual Volatility</th>
<th>Growth of $1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Five-Year U.S. Treasury Notes</td>
<td>5.1%</td>
<td>4.5%</td>
<td>$28</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>9.8%</td>
<td>20.0%</td>
<td>$529</td>
</tr>
<tr>
<td>Dimensional US Small Cap Value Index</td>
<td>13.2%</td>
<td>30.9%</td>
<td>$3,930</td>
</tr>
</tbody>
</table>

Source: Dimensional Fund Advisors.

Some very smart people still believe that what Fama/French “discovered” were market inefficiencies in small cap and value stock pricing—an anomaly, in other words. Most professional investors have dismissed the research and yet have failed to exploit the supposed anomalies. Or just maybe they’re not anomalies: returns over the past 23+ years have turned out very similar to the 88+ year returns, while volatility has fallen.

Index Returns: January 1995 to March 2017

<table>
<thead>
<tr>
<th>Index</th>
<th>Annual Return</th>
<th>Annual Volatility</th>
<th>Growth of $1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Five-Year U.S. Treasury Notes</td>
<td>5.3%</td>
<td>4.2%</td>
<td>$3.13</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>9.7%</td>
<td>14.8%</td>
<td>$7.88</td>
</tr>
<tr>
<td>Dimensional US Small Cap Value Index</td>
<td>14.4%</td>
<td>19.9%</td>
<td>$19.81</td>
</tr>
</tbody>
</table>

Source: Dimensional Fund Advisors.

We’ve also learned that combining a total market index fund with small cap and value asset class funds results in portfolio volatility that is less than the weighted average of the individual asset classes.

But Some Can’t Leave Well-Enough Alone

We are in the midst of a trend in investing moving away from human-to-human communication and toward a much more impersonal approach. This is certainly true of the “robo-advisor” movement, in which computer algorithms use historical risk and return numbers for a wide range of “asset classes” to develop “optimal” portfolios for investors looking to save money on advisory fees. Along with very simplistic online questionnaires designed to determine an investor’s risk tolerance, these systems assume a one-size-fits-all solution will work for everyone with a certain perceived risk profile.

Investors are asked questions and offered solutions that place far too much emphasis on short-term volatility (computed on a yearly basis—not the 5, 10, or 15-year rolling time periods more appropriate to long-term investors). Furthermore, whatever conclusions Blinky the Computer makes about a person’s tolerance for investment risk, there is virtually no effort at altering what are almost certainly unrealistic expectations of asset class risk and returns over longer time periods.

Equius knows this well from our review of the “Stocks Reward Patience” posters we’ve created to help investors look beyond 1-, 2-, or 3-year time frames. When we help our clients understand stock risk better than the average investor does, most are able and willing to accept higher levels of volatility in the short-run to realize potentially higher compounded rates of return over their total investment time horizon. The impact on total wealth accumulation over time by applying this much more personal, time-consuming, and disciplined investment counseling can be enormous (see the “Growth of $1” column in the accompanying tables for reference).

To compete with the robo-advisors, many of our peers are simply moving in the same direction (of less human interaction) and applying a “kitchen sink” approach to portfolio allocation. This overly broad, less productive, and unnecessary move robs investors of expected returns, while hardly making a dent in volatility during extreme down markets. It also saves on education and personal coaching efforts on the part of the advisor—but these are expensive yet very fruitful services (for both advisor and client) if done more thoughtfully.

Our Commitment

One thing (among many) that sets Equius apart is a documented history—through 23 years of Asset Class articles—of boiling asset class investing down to its essence and sticking with it through thick and thin. This doesn’t mean we’ve stopped learning. What it means is that we don’t do things for marketing or competitive business reasons that ultimately diminish the financial outcome (net of fees) for our clients. As we face continuing challenges in the financial markets and our industry, you can rest assured that our principles will not be compromised.
