



Performance Expectations

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Last year was challenging for investors. The broad stock market averages—the S&P 500 index for U.S. stocks and the MS EAFE index for non-U.S. developed markets—were down -4.4% and -13.4%, respectively. Equius clients felt an even greater impact due to larger declines in global small cap and value stocks. Adding insult to injury, the returns from short-term, high-quality bonds remain relatively low historically.

This kind of experience understandably creates doubts about whether a global asset class investing strategy make sense for you. Failing to consider why you made this choice in the first place will place you at risk of getting back on the investing merry-go-round and moving from one pretty horse to another—increasing your stress and ultimately destroying your hard-earned wealth, which is not likely to be built up again without taking risks that are unacceptable to you.

Perhaps it's a good time to remind yourself why you chose Equius and our asset class investing strategy as your long-term solution for growing and preserving your wealth. This article and more to follow will offer a framework that can serve as your reminder.

Let's begin, though, with a snapshot of what you most likely left behind: traditional, speculative active management. Over the past 15 years, 83.8% of all domestic stock mutual funds, 92.7% of U.S. large-cap funds, and 98.6% of U.S. small-cap funds have underperformed their respective unmanaged indexes.* And these funds are managed by the *professionals*. Clearly, traditional stock picking and market timing are not the answer.

What have we pledged to deliver to you and why?

From purely an *investment* perspective and within appropriate and personalized risk parameters, what Equius strives to deliver in the most optimal way are **market returns** and any **return premiums** available within those markets that are supported by logic, common sense, and the very best academic research.

That's a mouthful, so let's break it down:

- “Investment perspective” describes an expertise that is just one aspect of our potential value to you. A sound investment strategy is only as good as the discipline to see it through, so our ongoing counseling is very important to your long-term success. Furthermore, over the course of our relationship, we'll encounter a plethora of financial planning challenges that we will work with you to resolve.
- “Appropriate and personalized risk parameters” acknowledges that not everyone has the same financial needs or life goals. To develop and manage a portfolio tailored to your situation, we must fully understand your needs and aspirations and how *all* the pieces of your financial picture fit together.
- “In the most optimal way” encourages us to seek partners (like Dimensional) who are aligned with us philosophically and offer investment vehicles and other services that consider diversification, tax efficiency, costs, and other important factors to optimize the risk/return trade-off. Because we want portfolio turnover to be minimized, it's essential that we're confident these will be long-term partnerships we can count on.
- “Market returns” recognizes that we are well aware of the consistent failures of active management (and the reasons behind them) and therefore will not put our egos (or yours) ahead of the science. In other words, we will not speculate with your money by subjecting it to the very low odds of success offered by non-market solutions based on forecasts and predictions.
- “Return premiums” (also called “risk premiums”) means we understand and accept the science that indicates securities vary in their *expected* returns (due to differences in perceived risk) and we believe these premiums can be realized over time with exceptional portfolio structure.
- “Supported by logic, common sense, and the very best academic research” signals that we will always search for irrefutable evidence and sound financial research from only the most highly regarded sources. We will not feed fear, greed, or any other emotions associated with investing. We

will never place slick marketing ahead of the harder task of appealing to your intellectual curiosity.

Is there a good framework for evaluating whether we've delivered on our promise?

In a recent interview, Gerard O'Reilly, co-CEO of Dimensional, suggested these four steps for investors looking to assess investment performance:

- (1) You should fully understand the **investment objectives** of our strategy,
- (2) You should understand the **specific approach** we use to achieve those objectives,
- (3) You should have **realistic expectations** about relative performance **in different market environments**, and
- (4) You should know what appropriate tools, analysis, and resources are available to **monitor and explain returns**.

We believe these steps are most useful when applied consistently in a *systematic and structured approach*. One reason why stock picking and market timing fail so miserably so often is that these four steps are constantly moving targets. We see this same challenge with do-it-yourself investing, which is why Equius has always emphasized the value of our "firm hand on the tiller." Fortunately, we have over 25 years of *AssetClass* articles on our web site that show our commitment to this important principle.

A *systematic and structured approach* should be fully *transparent*. Transparency promotes honesty and integrity. It also encourages the healthy skepticism and engagement that any investment advisor should be willing and able to address in a professional and empathetic way.

A *systematic and structured approach* can also help explain expectations about relative performance in different market environments. Verifying whether those expectations have been met is easier with a structured approach and can help you stay the course and become a more successful long-term investor.

For example, we *expect* value stocks to underperform the broad market over certain periods—it's in the data (which I'll show in the next issue). While this underperformance can be disappointing, what's important is that we can demonstrate that we've remained invested according to your investment policy statement, controlled what we could control, and added value where we could.

Realized returns, compared with *expected* returns, are "noisy" because market prices reflect the

aggregate expectations of investors, and changing prices are based on new information, previously unknown events, emotion, herd behavior, and so on. Day-to-day and month-to-month price changes are unpredictable. Therefore, the more noise in the data, the less useful it is in either selecting or evaluating a sound investment strategy like asset class investing.

Strategies that allow you to learn something useful from *realized* returns can help you stay the course.

What can we do to make stronger inferences from the data?

Increase the number of observations. When forming expectations about the future, 20 years of data is better than 12 months, and 80 years of data or more is even better. Of course, observing is one thing. Analyzing and explaining is another. That's where logic, common sense, and great academic research come into play.

An extended data record combined with top-notch academic science forms the foundation of our long-term investing approach. Upon that foundation, we build a portfolio structure using the best tools available, develop rules on managing the structure (with rebalancing as a key task due to its risk management benefits), and foster a strict discipline that keeps you and us from short-term, potentially costly deviations.

What role do benchmarks play in this process?

For Equius and our asset class investing strategy, benchmarks are most useful at the fund level. We want to know how asset class and index funds perform relative to an *appropriate* benchmark. For example, we expect value stocks to outperform the broad market over time. But in both the short and the long term, we want to know how a fund performs relative not to the broad market, but to a *value* benchmark. This requires that we fully understand the structure of both the benchmark and the fund(s) we invest in for your portfolio.

Over time, we should expect a small-cap and value tilted portfolio to outperform the broad market. "Over time" is the operative phrase here, and that's what I'll deal with, along with data, in the next issue of *AssetClass*.

Much thanks to Gerard O'Reilly for valuable insights and inspiration for this article.

**Standard & Poors SPIVA U.S. Scorecard report, [mid-year 2018](#).*

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