# So Long That It Seems Wrong

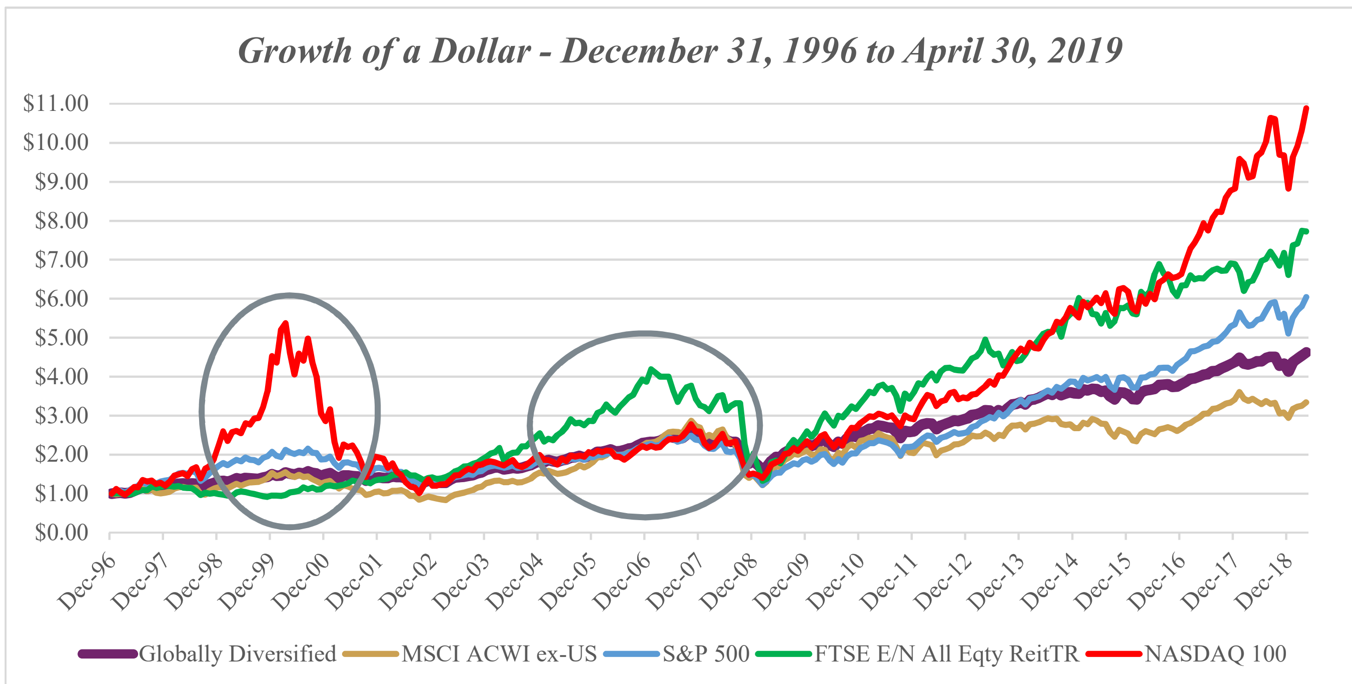
by: The RGT Investment Management Team | July 2019

**“The investor who says, ‘This time is different,’ when in fact it’s virtually a repeat of an earlier situation, has uttered among the four most costly words in the annals of investing.”**

**Sir John Templeton, *Investment Success*, 1933.**

Sometimes investment market trends are so strong, and extend over so many years, that even time-tested approaches, such as disciplined, diversified asset allocation strategies, can seem “out of touch”. Oftentimes this belief in “the trend” reaches its zenith just as the trend begins to run out of momentum. Over time these cyclical trends have been a regular occurrence, and since the financial crisis of 2008-09, markets have provided another example of a strong trend that, like all the others that came before it, will likely someday end. When it does, investors who are over allocated to these “hot” and “popular” strategies are likely to suffer significant declines and poor performance in their investment portfolios.

The section below revisits several speculative bubbles that, upon bursting, resulted in rapid reversals of fortune and significant portfolio losses for portfolios that were overallocated to the asset classes and securities at the heart of the bubble. The chart below highlights two periods where a particular asset class came to dominate market returns and seemed to confirm a narrative that something fundamental had changed in the world. This narrative, which occurs over and over throughout history, seems to often include the phrase “this time is different” as a rationale for why markets are behaving in ways that seem to contradict long-term market fundamentals. The two periods circled below are the technology boom and subsequent bust of the late ‘90’s into 2002, and the real estate boom and subsequent financial crisis of 2008 and 2009. During the tech bubble of the late 1990’s technology, internet, and other growth stocks, as represented by the NASDAQ 100 Index, far outpaced other asset classes before returning to earth with a resounding thud beginning in 2000. During the real estate bubble of the early/mid 2000’s real estate prices, in this case represented by the FTSE E/N All Equity REIT Total Return Index, exhibited a return pattern similar to tech stocks – a dramatic run up followed by an ignominious crash.




Source: Bloomberg | Globally Diversified Allocation – Bloomberg Barclays Municapal Bond Index 35%, Russell 3000 33%, MSCI ACWI ex-US 22%, FTSE E/N All Equity REIT 5%, S&P 500 Energy Index 5%

The table below further illustrates the similarities between today's equity markets and the markets of the late 1990's. In both cases the U.S. large-cap growth stocks (Russell 1000 Growth) have generated three-year cumulative returns that are 2.1 times the cumulative returns of U.S. large-cap value stocks (Russell 1000 Value). The table on the far right shows the impact of the bursting of the tech bubble and how value stocks held up better than growth by a wide margin.

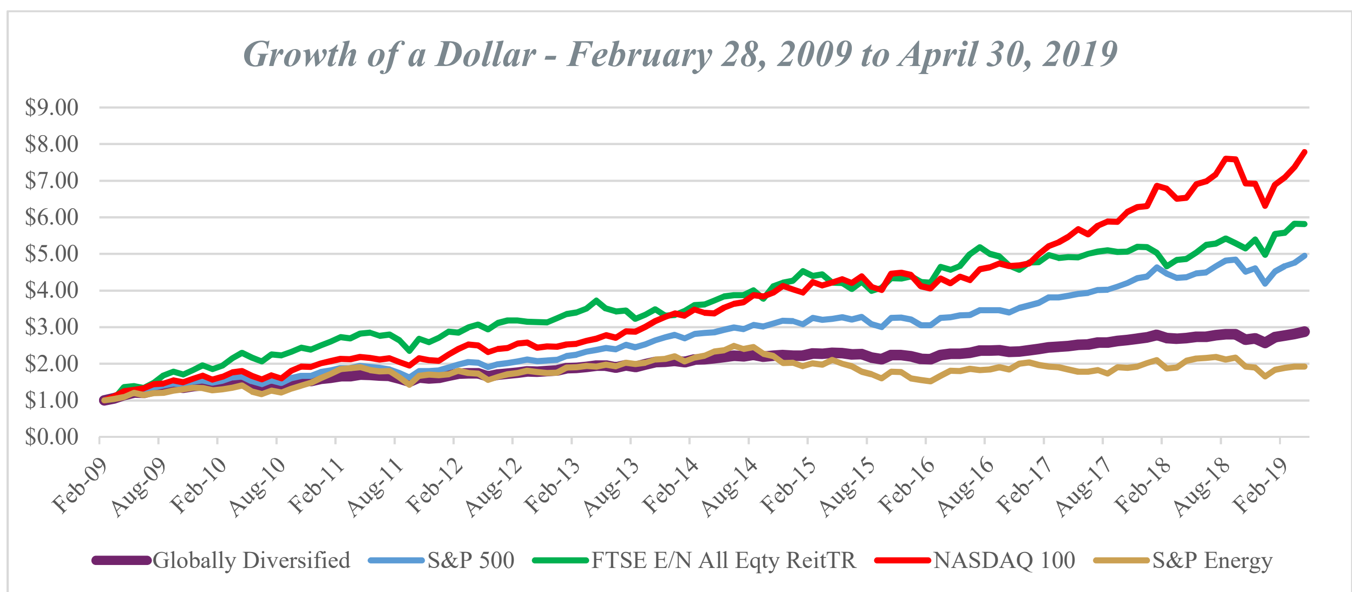
| **Last 3 Years of the Tech Bubble** | | |
|---|---|---|
| Year | Russell 1000 Growth | Russell 1000 Value |
| 1997 | 28.7% | 34.8% |
| 1998 | 35.0% | 13.5% |
| 1999 | 33.8% | 6.7% |
| **Cumulative** | **132.5%** | **63.3%** |
| **Growth vs. Value Multiple: 2.1X** | | |

| **Most Recent 3 Years** | | |
|---|---|---|
| Year | Russell 1000 Growth | Russell 1000 Value |
| 5/16-5/17 | 3.9% | -0.4% |
| 5/17-5/18 | 21.4% | 8.7% |
| 5/18-5/19 | 20.3% | 15.1% |
| **Cumulative** | **51.7%** | **24.7%** |
| **Growth vs. Value Multiple: 2.1X** | | |

| **3 Years Following Tech Bubble** | | |
|---|---|---|
| Year | Russell 1000 Growth | Russell 1000 Value |
| 2000 | -22.4% | 8.0% |
| 2001 | -19.6% | -4.3% |
| 2002 | -28.0% | -15.2% |
| **Cumulative** | **-55.1%** | **-12.4%** |

We now find ourselves ten years into a long bull market rally following the financial crisis. And, as illustrated above, we are starting to see some of the same characteristics in market performance that were present prior to previous reversals in market fortune. Once again, stocks in the NASDAQ 100 Index have outperformed other equity asset classes by a startlingly large margin. And REIT stocks are not far behind. Is it possible a correction back to longer term averages happens? Does an over-allocation to strategies concentrated in these areas seem prudent based on historical cycles and precedent? Or, are things truly different this time? Of course, we know how the subsequent three years worked out following the tech bubble. And we acknowledge that there is no way for us to know how the next three years will play out. In fact, it seems unlikely that they will be an exact mirror of the 2000-2002 time period. However, to ignore the risks implied by how markets have behaved during similar time periods in the past would seem to be derelict in our duty as investment professionals.

Focusing more specifically on the last ten years following the financial crisis, we see that the recovery in the last decade has been especially favorable for growth stocks. Real Estate Investment Trusts have performed well also, at least in part due to declining interest rates. In addition, U.S. large stocks (S&P 500) have generally performed better than foreign stocks (MSCI EAFE). Energy stocks have lagged over this period. These trends can be seen in the graph below.

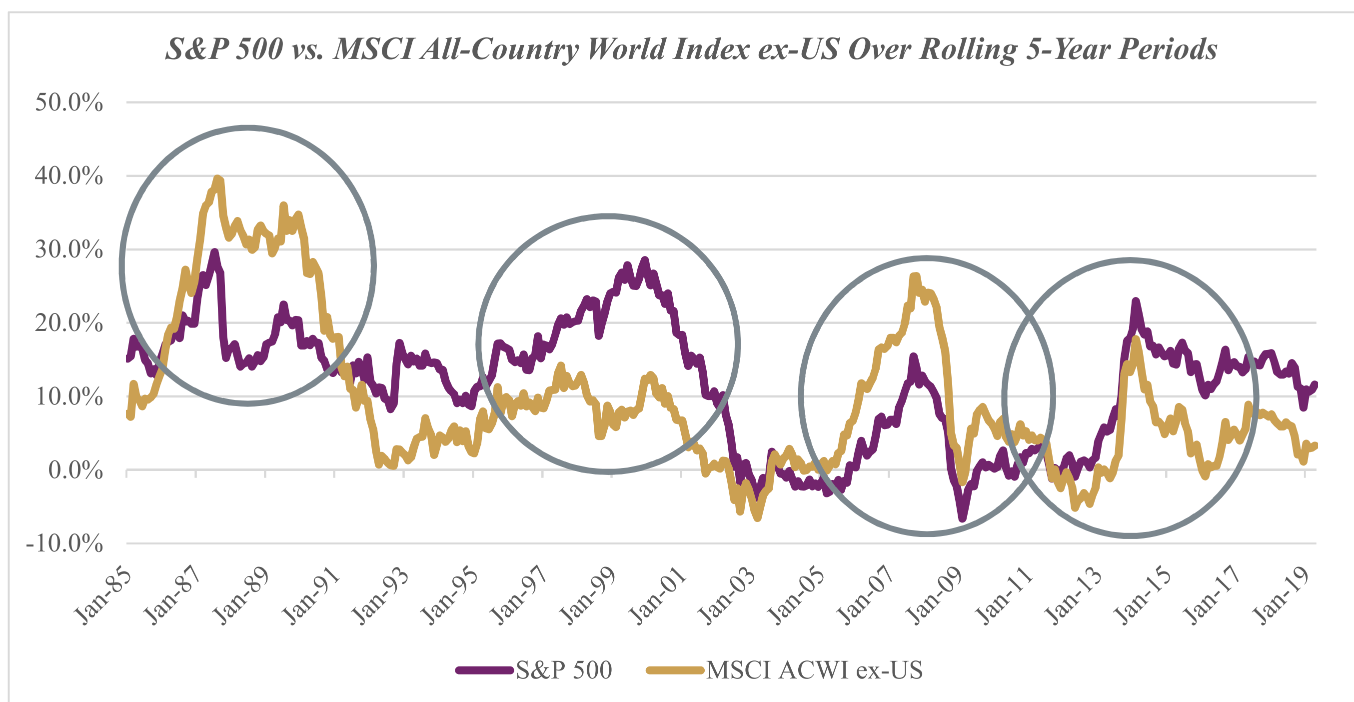



Source: Bloomberg | Globally Diversified Allocation – Bloomberg Barclays Municapal Bond Index 35%, Russell 3000 33%, MSCI ACWI ex-US 22%, FTSE E/N All Equity REIT 5%, S&P 500 Energy Index 5%

The NASDAQ 100 stock index has performed well due to its exposure to technology, social media, software and bioscience companies such as Amazon, Amgen, Facebook, Microsoft, and Netflix. This market segment had been on a strong upward trend until the most recent month of May 2019, when it declined over 9% during the month. Also, notice the more rapidly rising line for large-cap U.S. equities (S&P 500) compared to the globally diversified portfolio.

This trend of outperformance by U.S. stocks, particularly U.S. large-cap growth stocks, has been tempting for some investors to chase as it continues year after year until it seems like an inevitable and "obvious" result to many investors. Behavioral finance has a name for this - hindsight bias - means when certain investments perform very well, some investors believe it confirms their prior held view that these large U.S. growth company stocks would do so well. Hindsight bias is simply the tendency of people to overestimate their ability to predict outcomes. In this case it "seems" obvious, in hindsight, that large-cap U.S. stocks were fated to outperform other asset classes. For example, Amazon's success may appear "obvious" in 2019 although its achievements were much more difficult to predict, and included many setbacks, over the past twenty years. Another behavioral trait – recency bias – will cause investors to predict current trends into the indefinite future, often with poor results, especially when "hot" or "popular" strategies turn negative. This short-term thinking by investors can be detrimental to ultimate long-term portfolio performance.

As mentioned above, the recent market cycle has been one in which the performance of U.S. stocks versus foreign has also been trending decidedly in favor of U.S. stocks. But if we take a longer-term view, as seen in the chart below, we see that performance differentials between U.S. and foreign stocks move in multi-year cycles, with performance leadership changing over time.

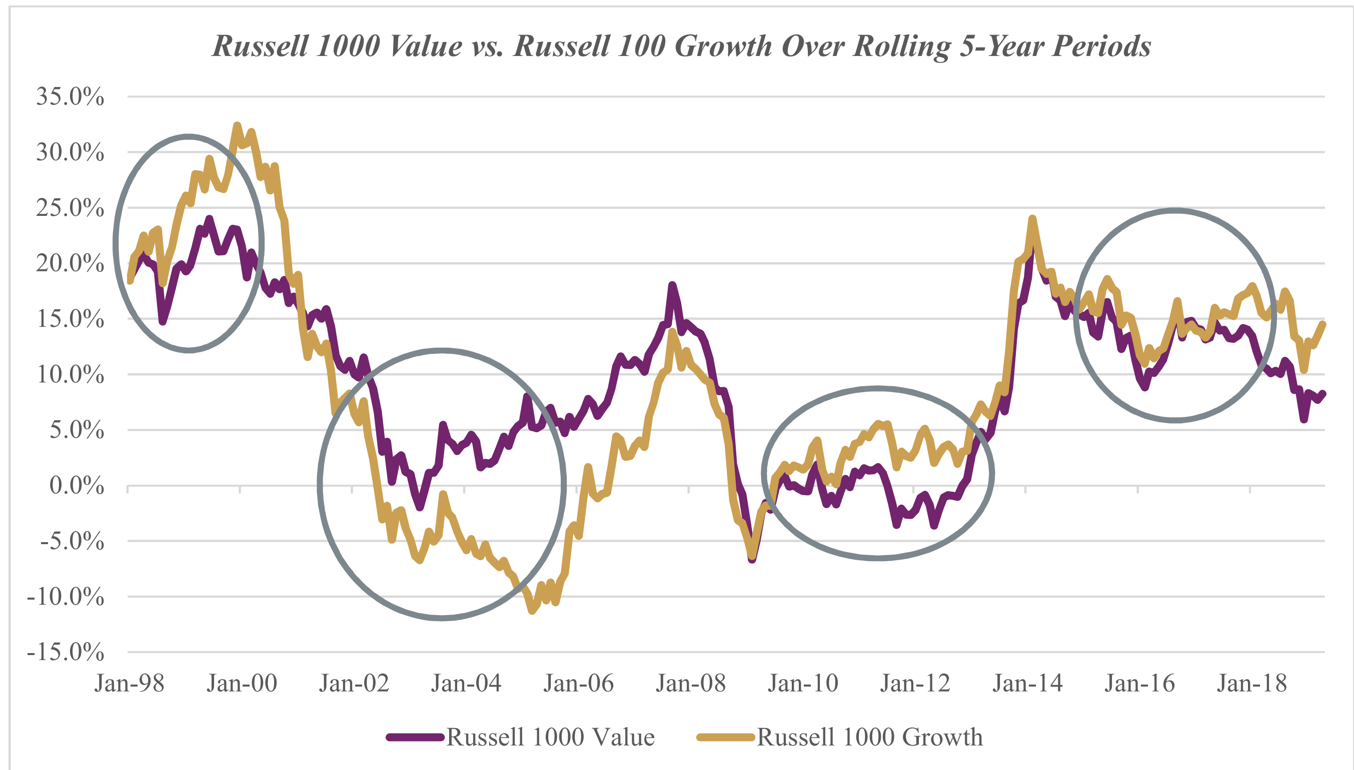



Source: Bloomberg

You can see this cyclical change in performance leadership clearly in the circled periods shown above. Over the last three decades, there have been two periods of outperformance for U.S. stocks and two periods of outperformance for foreign stocks, all lasting several years. During these periods, it is often difficult for investors to understand how the trend might change, but it inevitably does and performance leadership flips, generally for several years at a time. This cyclical reversion to the mean of market returns may be due to valuation corrections,

changing market sentiment, varied rates of economic growth across regions or a combination of these and other reasons. Exactly when these markets transition is difficult, most probably impossible, to predict. As U.S. stocks have continued to outperform in the last several years (except during 2017 when foreign stocks outperformed for the year), market valuations for U.S. stocks in aggregate have come to look somewhat overvalued relative to their foreign counterparts. Fluctuating interest rates and the cyclical nature of economies and business fundamentals can also provide shifting periods of outperformance for different asset classes and market sectors. Might we be at an inflection point now? History would suggest this as a possibility as illustrated by the above chart. How does a potentially weaker U.S. $ impact the performance of domestic vs. international equities?

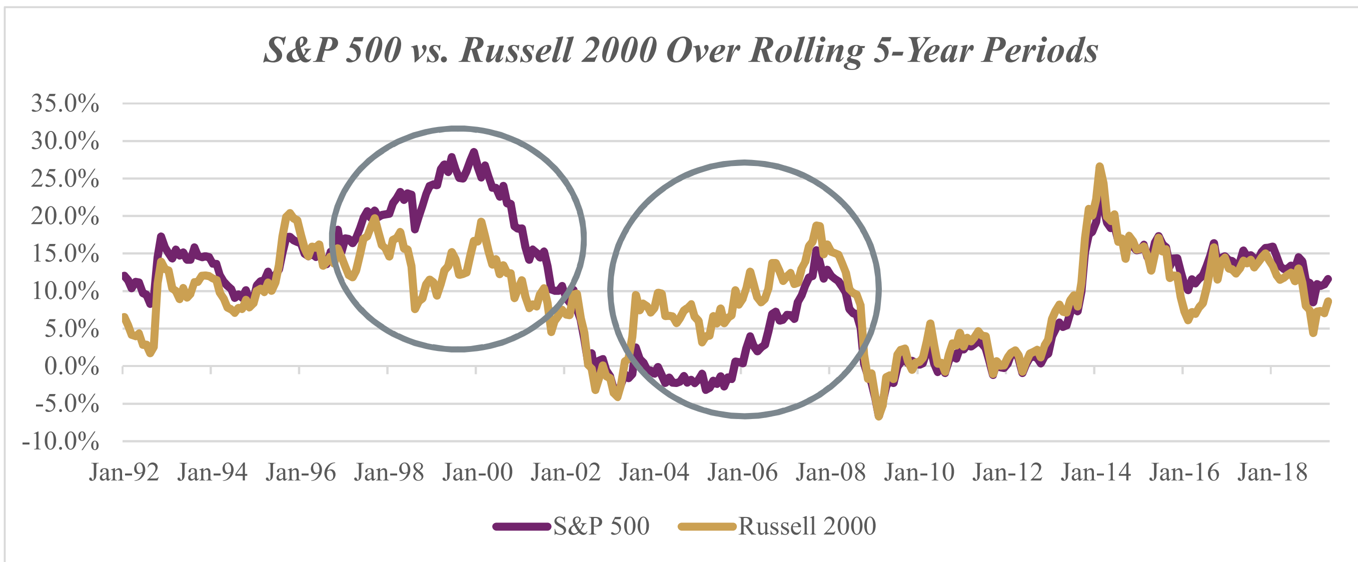
A similar cyclical trend can be seen in the performance differential between U.S. large-cap growth stocks (Russell 1000 Growth) and U.S. large-cap value stocks (Russell 1000 Value). Earlier we showed how growth and value stocks have performed recently compared to how they performed at the turn of the latest century. If we take a step back and look at a longer time frame, we see cyclical performance that is very similar to that between U.S. stocks and foreign stocks. Most recently growth stocks have been consistently outperforming value stocks. This trend as indicated by the graph below, has largely been in place since the financial crisis of 2008-09. Growth stocks such as Microsoft, Apple, Amazon and Facebook are in this group. Value stocks in today's equity market include companies like Johnson & Johnson, Exxon Mobil, Procter & Gamble, Cisco Systems and Intel, which typically have more modest P/E ratios and lower growth rates.




Source: Bloomberg

When comparing growth versus value, investors can see four distinct periods where one of these two styles outperformed the other. First, in the late 1990's, during the technology boom, growth outperformed. Then, in the aftermath of the technology bubble bursting, value outperformed growth. Since 2009, growth has been the winning strategy between the two and this cycle has continued for an extended period. Is it time for a change in market leadership?

One last area to examine is the comparison between U.S. large-cap stocks (S&P 500) and U.S. small-cap stocks (Russell 2000). See the graph below.




Source: Bloomberg

During the period from 2002 through 2007, small-cap stocks, outperformed large-cap stocks by a wide margin. Since then, the two asset classes have traded more in line with each other, though large-cap stocks have recently outperformed. Will the current trade wars and currency fluctuations allow smaller companies in the U.S. to outperform in the next few years? Do U.S. multinational companies face headwinds they have not seen in many years in the form of inconsistent U.S. foreign policy, the strong dollar and questions regarding U.S. trade policy? Only time will tell.

As is typical of markets that have been dominated by strong and persistent performance trends, some investors have started to question the wisdom of a more diversified long-term approach to portfolio management. We field these questions on a regular basis in this type of environment. And the last few years have been no different. As investment professionals we have the luxury, and the responsibility, to step back and take a long-term big-picture view of the investment landscape. And when we do we see a familiar world.

Historically, over full market cycles, well diversified portfolios have produced attractive risk adjusted returns relative to undiversified or overly concentrated portfolios. In other words, proper portfolio diversification is often a wise strategy because for a given level of volatility/risk the diversified portfolio can help investors to maximize their returns. Less diversified portfolios may indeed achieve a higher level of returns, but they do so at the cost of increased risk and the potential for much lower returns as well. And over the short-term there will always be some strategy or subset of strategies some of which will outperform and some of which will underperform the diversified portfolio. Being able to identify the difference in advance is difficult (if not impossible) and fraught with risk, because getting that decision wrong can be ruinous to long-term portfolio performance.

When the investment cycle is late, and the world seems to have changed can be a time of great risk to investors. It is tempting to make significant changes in these times. And it is particularly tempting to chase hot performance. But we should follow Lady Macbeth's advice and "screw our courage to the sticking place" and maintain a disciplined approach, recognizing that market cycles occur and that, while they can last a long time, they all eventually end (at least so far). Doing this requires patience and discipline and is oftentimes difficult. But nobody ever said this would be easy.

Thank you for the opportunity to provide this information and analysis.
Please contact RGT if you would like to discuss these or other topics further.

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