



Why Investors Are Focused On U.S. Equities In 2018

By: Justin W. McNichols, CFA

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For many decades, a multi-asset class approach delivered superior returns with less risk. By approximately, equally weighting the major asset classes, an investor could earn 8-9% returns with far less volatility than a portfolio comprised solely of equities. However, in reviewing the last ten years, a simple equal weighting has failed to generate meaningful returns. This is the main reason for the negative media coverage of many of the famous multi-asset class foundation and endowment portfolio managers.

What has caused most asset classes to underperform their long-term average returns? First, in reviewing ten year returns ended 4/30/2018, it is clear that although U.S. equities and alternatives have underperformed long-term averages, the other main four asset classes have generated extremely low returns versus their historic norms. In fact, as shown below, excluding U.S. equities, the best performing asset class was up only 3.8% annually for the past decade.

Asset Class Return Divergence From The Long-Term Average

4/30/2018

	Last 10 Years Annual Return	Since 1977 Annual Return	Return Difference
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Domestic Equities	9.0	11.4	(2.4)
Foreign Equities	2.2	10.2	(8.0)
Natural Resources	(8.0)	6.5	(14.5)
Real Estate	3.8	11.0	(7.2)
Alternatives	3.3	5.5	(2.2)
Fixed Income	3.0	7.2	(4.2)
Equal Weighted Portfolio	2.2	8.5	(6.4)

Source: OPCM

So what caused these poor results? First, the global credit crisis of 2008-2009 caused a major recession followed by unprecedented central bank easing. The result was a combination of slow growth, record low interest rates, and a stronger dollar as the U.S. exited the global recession first.



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Foreign equities experienced twin headwinds of a very slow economic recovery and a strong dollar which negatively impacts markets outside the U.S. Natural resources were damaged by a commodities supply glut along with the strong dollar. Real estate (REITs) posted strong returns as their yields were higher in the low interest rate environment. However, they became overvalued, and once interest rates rose, their competing yields were less favorable. Finally, fixed income faced a continuous headwind from the Federal Reserve slowly normalizing interest rates from record low levels. As rates rose, the price of bonds fell, along with returns.

The unique and rare environment of the past ten years is slowly normalizing. As the environment normalizes, asset class returns should normalize. This normalization should equate to U.S. equities losing their title as the only strong performing asset class. As the U.S. dollar strength slows, and deep valuation discounts outside the U.S. markets are discovered by investors, we expect foreign equities and natural resources to see improved returns over the next ten years. A portfolio that is highly overweight to U.S. equities has a high probability of actually underperforming over the next ten years.

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