

## How the Market Produces Average Returns

On a call in late June, Adam Landau, a Partner in our Philadelphia office, brought up an important point about recent performance overshadowing strong medium-term performance. After the call, we looked at the history of returns from a 60/40 portfolio (defined here as 60% in U.S. Large Cap stocks and 40% in U.S. intermediate government bonds).

When you look at current five-year returns, a reasonable gauge of the medium-term results, they are decidedly average. This version of a 60/40 portfolio has produced an 8.6% annualized return, right on the historical average. Even when adjusted for inflation, a 5.3% annualized return is also fairly average.

The concept of pulling forward returns, or pulling forward fundamental trends, is a theme of the pandemic. Due to Covid-19 keeping people at home and glued to their screens, ecommerce sales exploded. But it turns out the expansion of online sales share was transitory. After all was all said and done, digital spending is on the same pre-Covid trajectory.

### FOLLOWING IN THE FOOTSTEPS OF COVID-19

The market may be experiencing the exact same phenomena. The S&P 500 strung together an impressive run of returns from 2019 to 2021 (31.5%, 18.4%, 28.7%). During Covid-19, the forward multiple expanded from 19x to 24x. Earnings growth has certainly contributed to the excellent market returns, but the inflating of the market P/E ratio in 2020 and 2021 can be viewed (in hindsight) as returns getting pulled forward. The market multiple has now deflated back to 15x.

Today's losses are tied to yesterday's gains. While it is easy to focus on recent performance, each series is linked together. You can't have one without the other. The recency bias clouds our market glasses. The same return sequence over the last three years, replayed in reverse order (with the bad returns upfront), have a much different behavioral reaction with clients even though, from a long-term perspective, the performance is the exactly the same.

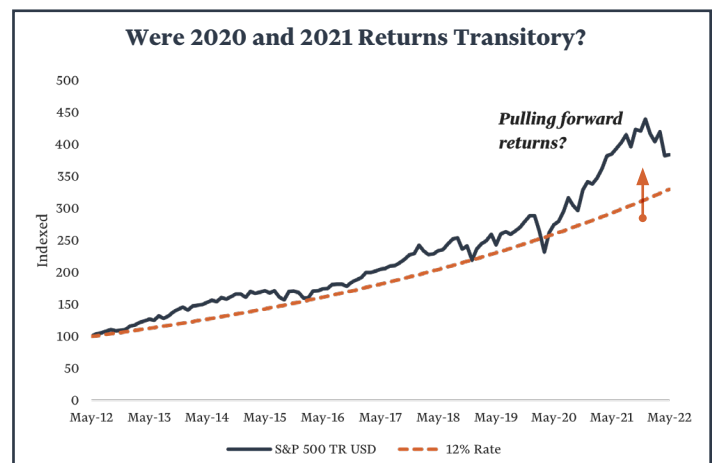
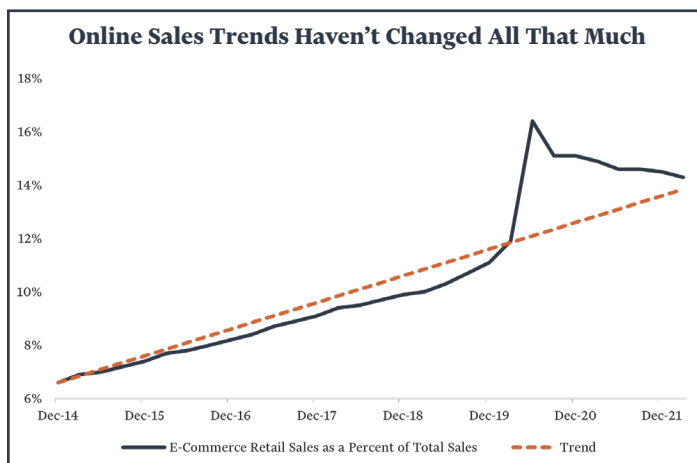
### THE NECESSITY OF RISK

It is worth thinking about why the equity risk premium exists. Despite entering a bear market and down 24% peak to trough, the S&P 500 grew at 13.4% per year over the past five years through the end of May. Going back to 1925, U.S. Large Cap stocks have delivered an average annualized five-year return of 10.25%. The 10% return figure that we all have engrained in our minds is far from a consistent growth rate.

If the market compounded at a steady 10%, all investors would forgo cash and fixed income instruments and put 100% of their savings into stocks. There would be no risk. The historical risk premium equities have enjoyed above bonds comes from that higher level of risk. Future cash flows can dry up. Multiples can contract.

Over the past 20 years, the S&P 500 had traded as high as 24x and as low as 8x forward earnings. To earn an annualized return of 10% means enduring years of up 29% (2021) and down 13% (2022). This is the very mechanism that produces average returns.

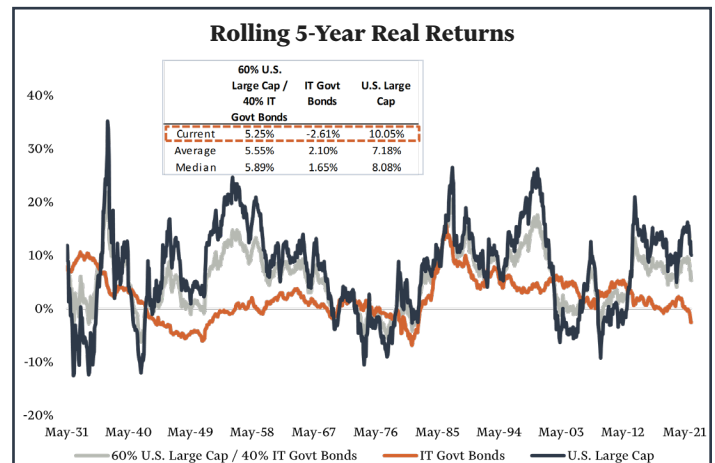
### THE PANDEMIC BROUGHT FORWARD THE FUTURE



Source: FRED, Morningstar Direct

## AVERAGE RETURNS

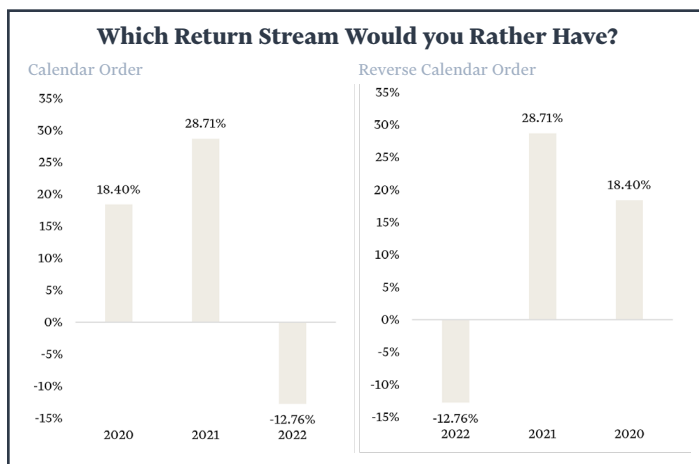
Despite a 10.3% drawdown YTD, over a 5-year timeframe a 60/40 portfolio delivered average returns



Source: Morningstar Direct

## SEQUENCING RETURNS

The order of a return matters to investors



Source: Morningstar Direct

### Not All Assets Experienced the Boom

Name	2017	2018	2019	2020	2021	2022	5 Yr
S&P 500 TR USD	21.83	-4.38	31.49	18.40	28.71	-12.76	13.38
Bloomberg Commodity TR USD	1.70	-11.25	7.69	-3.12	27.11	32.74	10.85
Russell 2500 TR USD	16.81	-10.00	27.77	19.99	18.18	-13.55	9.76
MSCI US RETT GR USD	5.07	-4.57	25.84	-7.57	43.06	-13.98	7.38
Credit Suisse Hedge Fund USD	7.12	-3.19	9.31	6.36	8.23	1.88	5.17
Bloomberg HY Muni TR USD	9.69	4.76	10.68	4.89	7.77	-8.86	4.26
MSCI EAFE NR USD	25.03	-13.79	22.01	7.82	11.26	-11.34	4.17
MSCI EM NR USD	37.28	-14.58	18.44	18.31	-2.54	-11.76	3.80
Bloomberg US Treasury US TIPS TR USD	3.01	-1.26	8.43	10.99	5.96	-5.95	3.68
ICE BofA US High Yield TR USD	7.48	-2.26	14.41	6.17	5.36	-7.76	3.42
S&P/LSTA Leveraged Loan TR	4.12	0.44	8.64	3.12	5.20	-2.45	3.35
Bloomberg Municipal 1-10Y Blend 1-12Y TR	3.49	1.64	5.63	4.23	0.54	-5.09	1.35
Bloomberg US Agg Bond TR USD	3.54	0.01	8.72	7.51	-1.54	-8.92	1.18
FTSE Treasury Bill 3 Mon USD	0.84	1.86	2.25	0.58	0.05	0.10	1.09
Bloomberg Treasury 5-7 Yr TR USD	1.87	1.44	6.79	8.48	-2.87	-7.47	0.99
JPM EMBI Global Diversified TR USD	10.26	-4.26	15.04	5.26	-1.80	-15.03	0.06
FTSE WGBI NonUSD USD	10.33	-1.82	5.32	10.78	-9.68	-14.54	-1.65

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