Quality Asset Management

Grow Your Wealth with Peace of Mind

Can the S&P 500 be dangerous?

By Gil Hanoch, April 6, 2005

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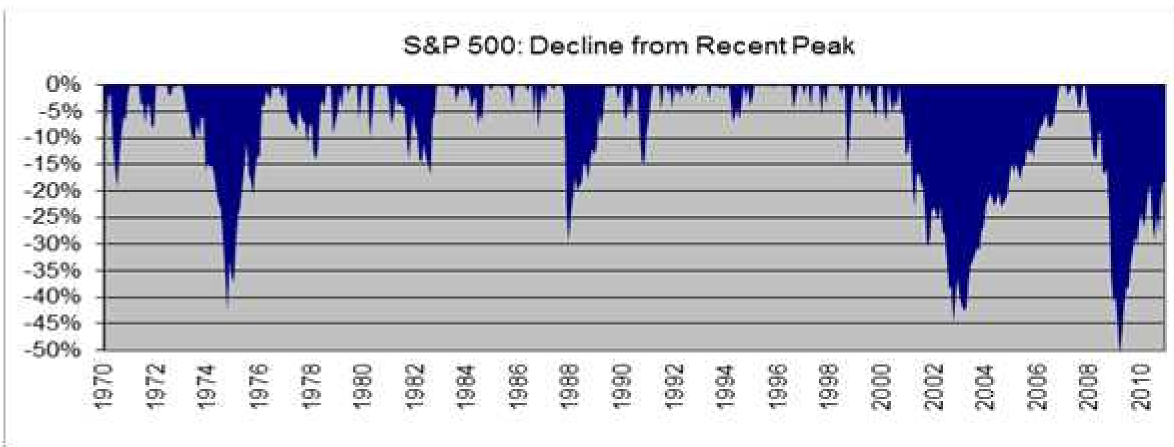
What is the S&P 500? It is a measure of the value of the 500 largest US Companies. This is not a stock or a mutual fund, but an *index* that tracks changes in the aggregate value of these companies.

Why do people love the S&P 500? The S&P 500 provides a measure of most of the US stock market, representing approximately 70% of the value of the market. Investing in a mutual fund that tracks the S&P 500 lets investors own a portion of 500 of the most stable companies in the world. Since it's not very likely that any of these companies will go bankrupt, it provides a great sense of security.

How much security does the S&P 500 provide? From 1970 to 2010, the S&P 500 grew by about 10% per year. This is a nice annual gain.

In order to evaluate the risks involved in investing in the S&P 500, we will observe the declines of the S&P 500. For each decline, we present the level of decline from the recent peak, until recovery.



The following is a summary of the prolonged declines (over 2 years) from 1970 to 2010:

Declines measured from peak to peak			**Sustained decline greater than 20%**	
When?	**How long?**	**Max decline**	**When?**	**How long?**
1/1973 – 5/1976	3 years 5 months	-43%	4/1974 – 3/1975	1 year
9/2000 – 10/2006	6 years 1 month	-45%	8/2001 – 10/2004	3 years 3 months
11/2007 - ?	3 years 1 month+	-51%	9/2008 – 3/2010	1 year 6 months

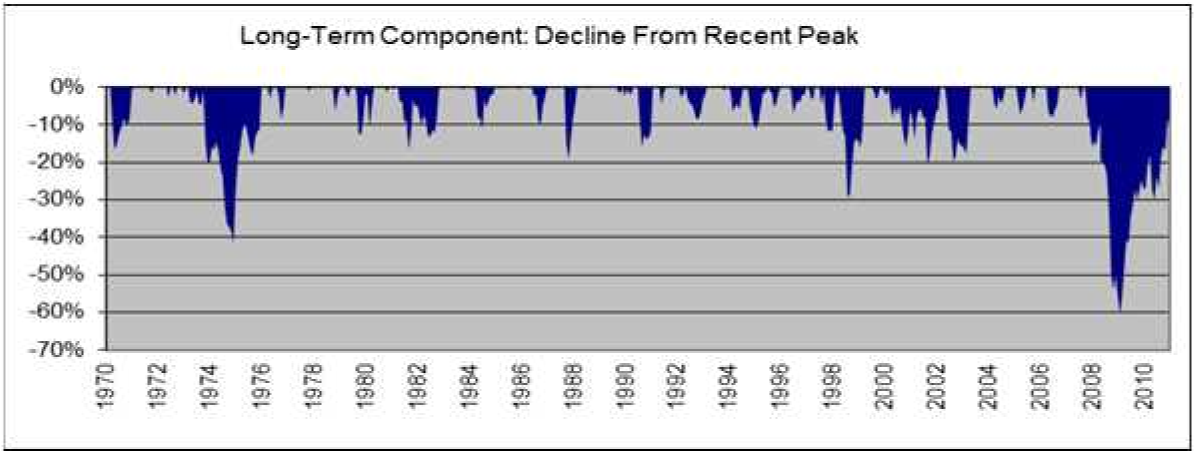
The danger: The S&P 500 declined for up to 6 years, sustaining a decline below -20% for 3¼ years and bottoming as low as -45%. This means that anyone who did not have reserves for the full period of August 2001 to October 2004, realized losses of over 20% and up to 45% since the recent peak.

Can you do better? You might find it hard to believe how much better you can do! The first part may not surprise you: by holding large and small companies all over the world (US, international and emerging markets), and focusing on cheap ones ('value stocks"), you can significantly increase your long-term returns.

An example of such a diversified portfolio (Long-Term Component by Quality Asset Management, made of Dimensional Fund Advisors mutual funds) will be used in the rest of this article. The annual growth of this portfolio from 1970 to 2010 (including simulation before the inception of the mutual funds) was 17.2%, 7.2% higher! In fact, the S&P 500 did worse than each of the mutual funds in the portfolio.

If you put $1M in the S&P 500 and the diversified portfolio in 1970, the S&P 500 would grow to $50M by the end of 2010, while the diversified portfolio would grow to $668M. That is a 1,336% difference.

At this point you might be saying, "This portfolio must be the riskiest portfolio to offer such high returns!" Let's look at the decline graph of this portfolio, similar to the graph above.

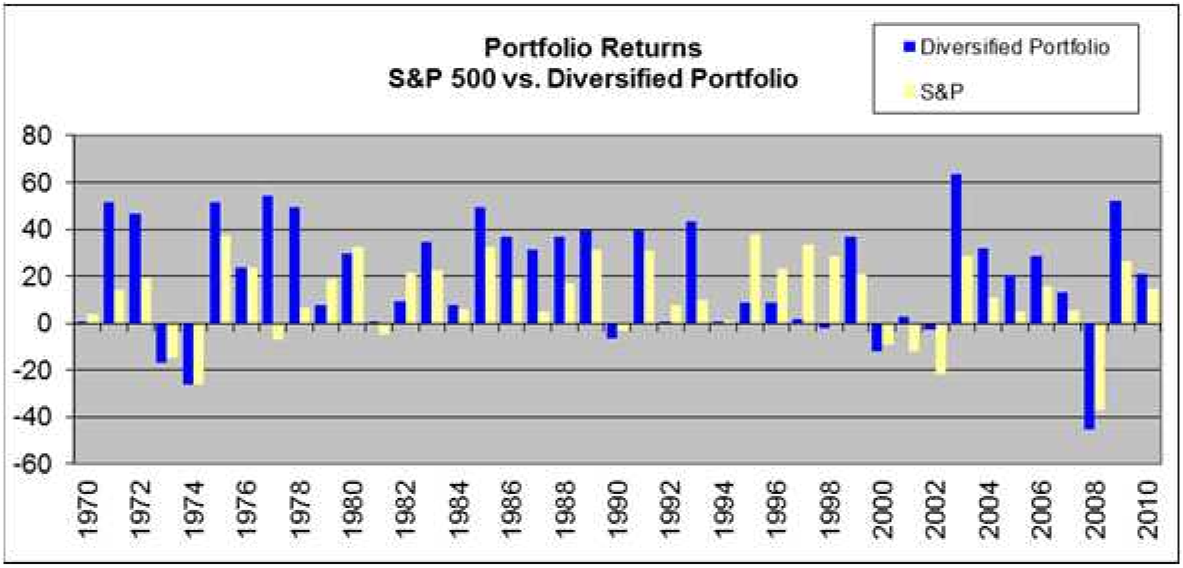


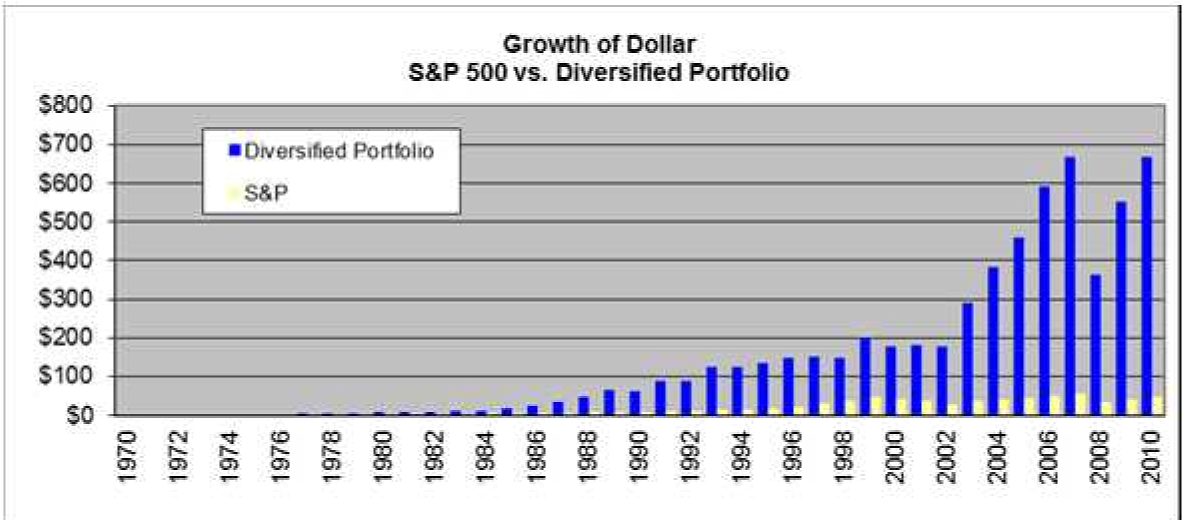
The following is a summary of the prolonged declines (over 2 years) from 1970 to 2010:

Declines measured from peak to peak			**Sustained decline greater than 20%**	
When?	**How long?**	**Max decline**	**When?**	**How long?**
4/1973 – 12/1975	2 years 9 months	-41%	6/1974 – 1/1975	8 months
11/2007 - ?	3 years 1 month+	-60%	7/2008 – 8/2009	1 year 2 months

The security: This portfolio had only two major decline in the last 40 years, lasting only an expected 3-4 years until full recovery, sustaining the decline below -20% for little over 1 year and bottoming at -60%. This means that with little over 1 year in reserves, you should have realized no loss greater than 20%. With 3-4 years of expenses in reserves, you would have realized absolutely no loss!

The full picture: So far, you saw only the down periods of the portfolios. Below you will find the annual returns and growth of dollar of the two portfolios, to get a better sense about their behavior.





How do less stable companies provide more security? The article started by explaining that people love the S&P 500 because it includes some of the most stable companies in the world. So, how come all these small companies, and even emerging markets provide more security? There are several reasons, including:

1. **Diversification**: The diversified portfolio presented has over 6,000 companies that go up and down in value in different times. While some of these companies may drop in value or even go bankrupt, the portfolio as a whole goes up faster.

2. **Faster growth**: Companies that are less mature and stable are likely to grow faster until they mature. This leads to much faster growth on average. In order to keep this long-term rapid growth, declines don't last for very long. In addition, recoveries have to be more significant. Specifically, after the 3 worst recessions, the diversified portfolio doubled (grew 100%) within 2 years!

3. **Lower popularity**: The S&P 500 is very popular. When people see it increasing rapidly, as happened in the 90's, they keep buying more and more of it, regardless of its price. That leads to large and prolonged declines, like in 2000-2002. The "herd effect" is not as prevalent in a globally diversified portfolio.

4. **Cheaper companies**: The diversified portfolio holds mostly cheap companies ("value stocks"). Their price compared to their earnings or book value is consistently lower

than for the market as a whole. This reduces the average declines of the portfolio in the long run.

To summarize

If history is any indicator of the future, you can get much higher returns than the S&P 500, with much higher security. There are no tricks to it, and no sophisticated predictions. All it takes is a one-time diversification plan and periodic rebalancing to keep the portfolio in line with the plan.

While most investors, including the most sophisticated ones, underperform the S&P 500[1], you can be in excellent shape without any market research and sleepless nights.

Why doesn't everyone hold a diversified portfolio? People tend to evaluate the security offered by an investment portfolio by evaluating the security of each component separately, rather than the investment portfolio as a whole. This leads them to conclude that a portfolio including large US companies and bonds would be safest. It is important to realize that all that matters is the performance of the portfolio as a whole. This allows you to achieve greater security *with* greater returns.

Closing notes

The results in this article cannot be used to guarantee future returns. They simply reveal historic performance based on real and simulated data. Also note that the results above were measured using a stock strategy globally diversified into over 6,000 companies and having low costs across the board, no stock picking and no market timing. Other strategies could lead to different results.

[1] Based on a report by Dalbar: "Quantitative Analysis of Investment Behavior", http://www.dalbarinc.com/content/printerfriendly.asp?page=2001062100.