



When Inflation Is Napping

A study of how asset classes fared during 15 years of low inflation offers some surprises.

By Craig L. Israelsen

As a runner, I've learned that the dogs to watch out for are the ones that don't bark – they're quiet, but dangerous. Inflation might be seen as one of those dogs – the same sort of silent risk. Although not currently a distinct threat, it may be poised to attack at some point.

It's also worth looking at how various asset classes have reacted lately while inflation has been low to try to find some investment lessons.

Inflation (as measured by the CPI) has averaged only 2.42% annually over the 15-year period from Aug. 1, 1999, to July 31, 2014. An examination of how various asset classes performed during this relatively quiet period may hold some surprises.

The last 15 years have been a challenging period for U.S. large-cap stocks,

although not because of inflation. As can be seen in the "Lump Sum Performance" chart, \$10,000 invested in U.S. large-cap stock (measured by the SPDR S&P 500 ETF, ticker symbol SPY) grew to \$13,315 over the 15-year period in after-inflation dollars.

The performances of U.S. mid-cap

stock and U.S. small-cap value stocks were significantly better over the same period, with ending balances of \$27,381 and \$28,562, respectively.

BEST PERFORMERS

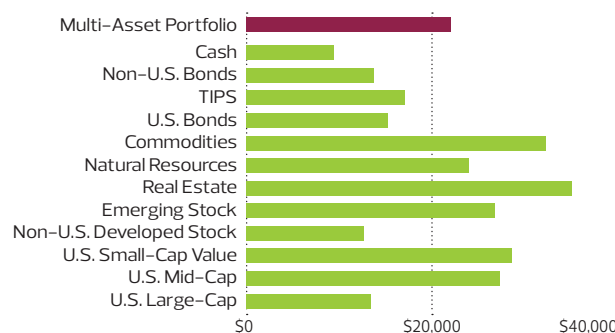
Perhaps more surprising, the asset classes that performed best after inflation over the past 15 years were real estate and commodities. An investment of \$10,000 in real estate (as measured by the Vanguard REIT ETF, or VNQ) grew to \$35,030, while commodities (the PowerShares DB Commodity Tracking ETF, or DBC) had an ending balance of \$32,141.

What makes this intriguing is that real estate and commodities tend to thrive during periods of high inflation.

Cash was the only asset class of these 12 to produce a net loss after 15 years. After inflation, its ending

Lump-Sum Performance

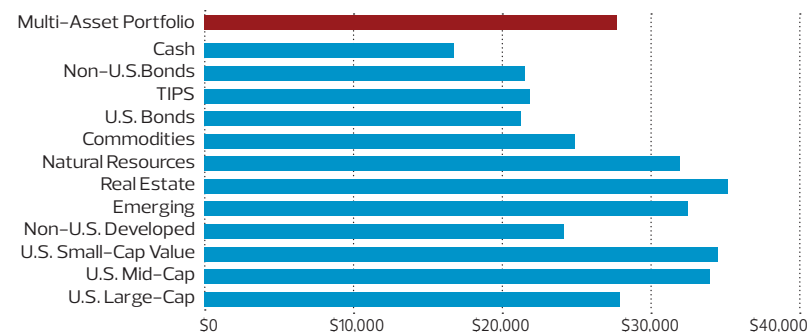
Compare the net value of a \$10,000 lump-sum investment made in either 12 individual asset classes or an equally weighted portfolio of all 12 for the 15-year period from Aug. 1, 1999, to July 31, 2014.



Source: Lipper, with calculations by author

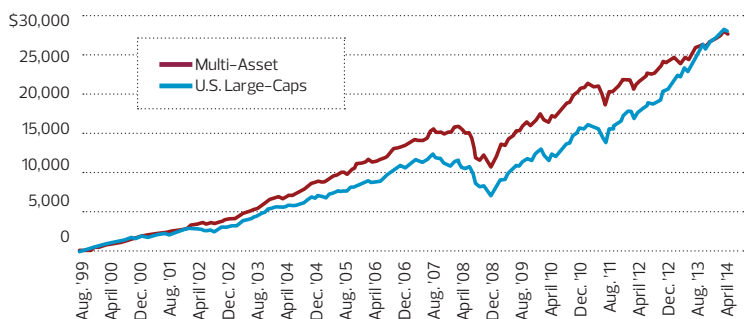
Monthly Investing

See the ultimate net value, after inflation, of a portfolio built with \$100 monthly investments — made between Aug. 1, 1999, and July 31, 2014 — and invested in either one of 12 individual asset classes or a multi-asset portfolio.



The Higher Road

Compare two portfolios made with \$100 monthly investments: one invested solely in U.S. large-cap stocks, and the other in an equally weighted 12-asset portfolio.



Source: Lipper, with calculations by author. Labeled in eight-month increments.

balance was just under \$10,000. But the job of cash is to be not a growth engine but rather a safe harbor, to protect investors from violent market losses.

I'm guessing that many advisors had clients who berated them for having too little in cash during 2008.

Cash is like a seat belt — vitally important when needed, but annoying the rest of the time. Nevertheless, we wear the seat belt all the time, and we likewise keep a prudent portion of the portfolio in cash. (The exact allocation, of course, should be determined by a whole host of specific client variables.)

Also shown in the chart is a multi-

asset portfolio that includes equal allocations of all 12 asset classes shown in the graph. A lump sum of \$10,000 in a multi-asset portfolio grew to just under \$22,000 in net terms.

Compared against the 12 asset classes, this blended result delivered a middle-of-the-road outcome. That is exactly what a diversified portfolio is designed to deliver: a respectable return with less volatility than the individual asset classes. Specifically, over the 15-year period being analyzed, the standard deviation of the 12-asset portfolio was 11.4%, compared with 23.9% for emerging country stocks, 22.1% for

real estate and 19.2% for U.S. small-cap value stocks.

Reducing volatility may not seem like a big deal as we look at past performance because we have the advantage of knowing how each investment worked out.

Real advisors living in the real world don't know the outcome in advance, of course, and times of volatility can cause fearful investors to abandon their portfolio game plan and take shelter in cash. But cash will not help clients grow their money over long periods of time. What investors really need is reasonable net growth with drastically less volatility.

SYSTEMATIC INVESTORS

Published annualized returns usually assume a lump-sum investment, but in the real world, it is more common for investors to invest systematically, making deposits monthly in a 401(k) or annually in an IRA.

The "Monthly Investing" chart shows the net growth (after inflation) of monthly investments of \$100 into all 12 individual asset classes, as well as into a 12-asset equally weighted portfolio.

It's worth noting that the final account value of a monthly investment in an all-commodities investment was below that of the multi-asset portfolio, while the opposite was true for the lump-sum investment. That's a timing issue: Commodities had better returns early in this 15-year period and lower returns in more recent years.

More broadly, systematic investment benefits from better returns later in the investment period when the account balance is larger, whereas the sequence of returns is immaterial in a lump-sum investment.

Next compare a U.S. large-cap stock investment against the multi-asset portfolio. The two finish with nearly identical account balances in a systematic investment scenario, but the multi-

asset portfolio beats U.S. large-cap stocks in a lump-sum comparison.

U.S. large-cap stocks have experienced strong returns in recent years – a pattern that favors a monthly investing scenario but is immaterial for a lump-sum investment.

PATH MATTERS

Let's examine the month-to-month account value growth, after inflation, of U.S. large-cap stocks and the multi-asset portfolio. The two investments ended the 15-year period with the same account value. But, as can be seen in "The Higher Road" chart, the 12-asset model had a higher balance for nearly the entire 15-year period.

Of course, a multi-asset model won't always outperform a single asset

class in this fashion. The key takeaway is that even if two systematic investments end up with the same account value after 15 years, it is important to consider the path they took.

That matters because investors may need to make withdrawals along the way – planned or unplanned – and it's ideal if the investment can maintain a higher account balance along the way.

Moreover, these results are after inflation; actual spending power is what investors ultimately care about. Keeping spending power as high as we prudently can from month to month – rather than relying on an individual asset class rally in the latter stages of an investment horizon – is a more logical and prudent strategy.

An investment portfolio that has

steadier performance will be the better choice for a systematic – monthly, quarterly or annual – investment plan. Because unplanned withdrawals could happen at any time, it is imprudent to expose the portfolio to asset classes that experience wide swings in performance. **FP**

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