Behind In Seven Of Ten Years, It Still Outperformed: 700 Words That May Change Your Lives

Saturday's With Jim

By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
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Dear Friends,

We want to illustrate today why investment should not be evaluated annually or anything less than a full market cycle. What seems best while looking up close can turn out not to be best when viewed by a long-term perspective.

Our Study

Taking the last ten years as an approximate full market cycle - beginning at the tail end of the 2002-2007 bull market, passing through the bear market of 2008 to early 2009 and continuing through the end of 2016 - we analyzed some performance measures of the Vanguard Dividend Appreciation Fund (VIG) and the SPDR S&P 500 Fund (SPY). Assuredly, had we varied the length, start and end of our study we may have achieved a different outcome in relative total return (how much your investment made overall), but the basic relationship between the two investments would have remained the same. VIG is a high quality, low volatility security that is about 15% less volatile than SPY. In a downturn, VIG will drop significantly less than SPY, but in a recovery and subsequent bull market it will frequently lag SPY. This said, VIG is far easier on your emotions as it does not expose you to thrilling gains and scary drops.

Results

VIG underperformed SPY in seven of the ten years studied, ahead of SPY only in the years in which SPY struggled. Yet, $10,000 invested in VIG at the beginning of 2007 would have grown to $19,612 at the end of 2016. SPY grew to $19,435. VIG gained 96% overall, SPY 94%. Perhaps the major factor in VIG's slight outperformance of SPY is its lower volatility and its tremendous outperformance in 2008. VIG has a volatility of 13.1 while SPY's volatility is 15.1 (higher readings indicate higher volatility). VIG dropped 26.4% in 2008 while SPY dropped 36.8%. This means that on a balance of $10,000 SPY dropped to $6,600 while VIG dropped to $7,700. Instead of the 15% average difference in volatility over the period, in 2008 SPY was about 50% more volatile than VIG.

So what does this all mean?

Put simply, VIG's construction makes it easier to hold in market downturns, while not sacrificing much in market upturns. The DALBAR data, which we have spoken about so much, indicates that the more volatile an investment is the more likely we are to sell in panic (sell low) and to buy closer to the high point (buy high). Steadier investments fit most people's emotional makeup far better than more volatile investments. Looking over the full market cycle, small frequent sacrifices are more than made up in market downturns.

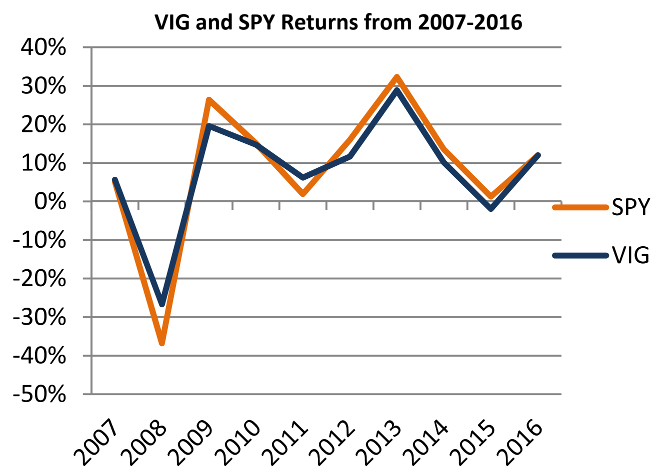
We can extend the study's design and results to a portfolio that is systematically managed using either of the funds as a performance and characteristics benchmark. We invest more in the VIG style, but as opportunities indicate, we will buy into more volatile securities in relatively modest amounts if they appear to have a low risk of loss. The point in the market cycle at which we buy will dictate how much volatility we should accept. Right now, we are dialing back volatility in the U.S while dialing it up overseas by holding an appropriate amount of emerging markets (EM) securities. EMs have higher volatility than securities in developed markets like the U.S.

It will take a lot of faith in an investment process to fall behind the performance of an investment like SPY in rising markets, but if there isn't a high tolerance for the volatility of account balances it's exactly what we should do. If investors get outside the comfort zone by too much, they will be moved to quit an investment program at the worst of times – when it's been down long enough to lose heart that it will come back and rise to new heights. Fortunately, the tortoises know that patience in investing usually wins the long day even though there may be lags at specific points along the way. Yes, I am a tortoise that has been genetically engineered to sprint at times – when the coast is clear.

Annual Results

VIG and SPY Growth of $10k from 2007-2016

Year	VIG	SPY	VIG Outperformance
2016	$ 19,612	$ 19,435	$ 177
2015	$ 17,515	$ 17,353	$ 162
2014	$ 17,864	$ 17,138	$ 725
2013	$ 16,228	$ 15,105	$ 1,122
2012	$ 12,592	$ 11,417	$ 1,176
2011	$ 11,278	$ 9,843	$ 1,436
2010	$ 10,624	$ 9,660	$ 964
2009	$ 9,259	$ 8,396	$ 863
2008	$ 7,744	$ 6,644	$ 1,100
2007	$ 10,563	$ 10,514	$ 49



Data from Morningstar, Inc., Sept.8, 2017, based on market price

We are grateful that you chose us to facilitate your financial journey. Thank you for investing with us.