Behind In Seven Of Ten Years, It Still Outperformed: Part II. The Why

Saturday's With Jim

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Key Points:

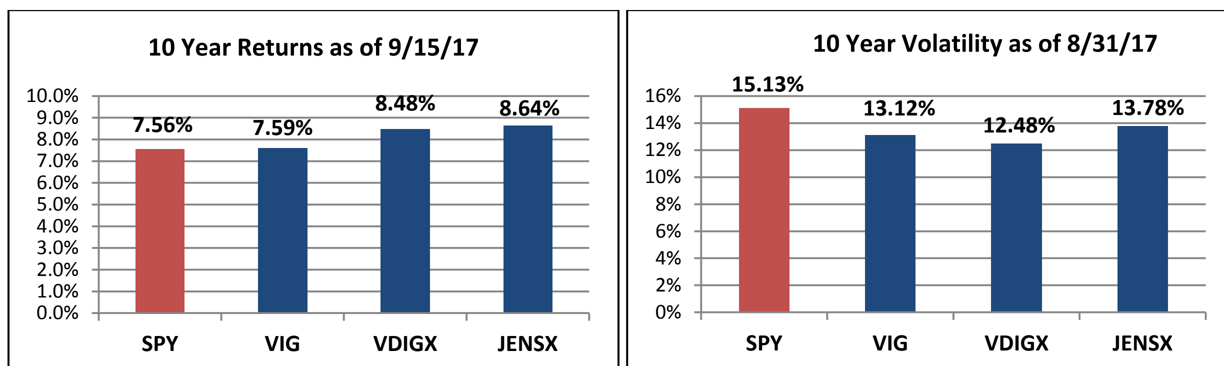
- An investment that underperforms a benchmark index for seven out of ten years may still outperform the index over the entire period.
- Selecting an investment portfolio based on profitability (quality) shows lower volatility than an index and may outperform it in a period that includes a deep and prolonged market drop.
- Evaluating investments over anything less than a market cycle may lead to false conclusions.
- At Gaia, we want to fill your portfolios with durably profitable (quality) securities.

Dear Friends,

Last week we noted how a lower volatility, high quality fund, Vanguard Dividend Appreciation Index Fund (VIG), gained a bit more money than the widely accepted U.S. stock benchmark, the Standard & Poor's 500 Index as represented by the popular SPDR S&P 500 Index Fund (SPY). We also noted that VIG outperformed SPY in total return (all sources of return combined) in only three of the ten years studied from 2007-2016. If we had only held VIG or investments like it from 2009 to the current date, many of you might have questioned our investment work for want of the faster gaining SPY. Yet, viewed from the year of the Great Financial Crisis (GFC) to last December, we would have slightly outgained the SPY and with lower year to year volatility, too. But does the VIG-SPY study give us anything we can replicate going forward? What is the source of VIG's win? Is it VIG alone that could have outperformed the S&P 500? Hint: the factor underlying VIG's outperformance is the same factor that drives Gaia's investments for you. It also drives the performance of the funds in the following study.

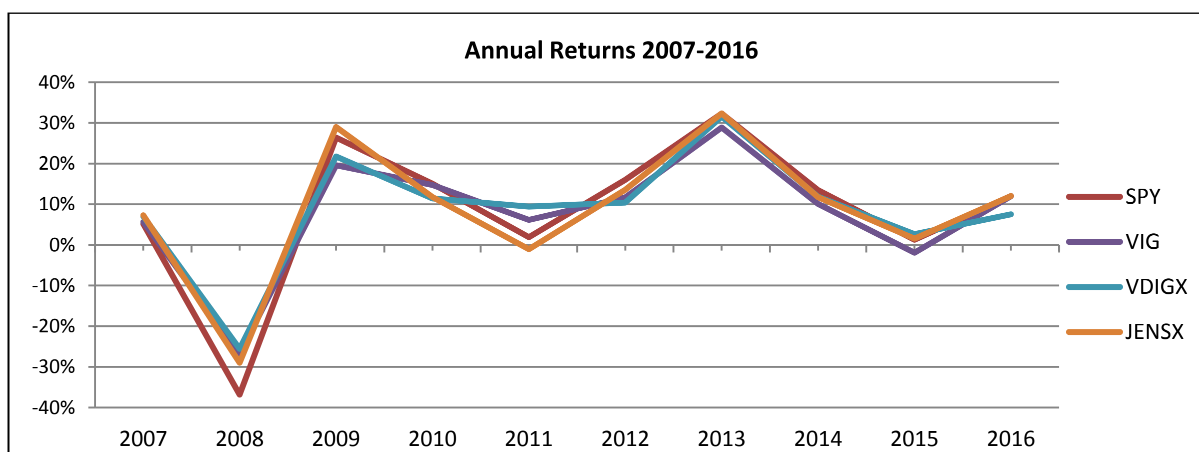
Replicating VIG Outperformance With VDIGX and JENSX

When we analyzed two additional high quality funds like VIG - Vanguard Dividend Growth Fund (VDIGX) and Jensen Quality Growth Fund (JENSX) - we found that both, like VIG, outperformed SPY (the index) over the ten year study period with smoother year to year performance. It's important to many people that their investments not fluctuate wildly from year to year because severe drops can cause extreme anxiety. The charts and table below show all four funds analyzed this week and last.



Source: Morningstar.com, extracted 9/16/17

The line chart below, of returns for the four funds across the ten year study period, shows the source of the outperformance by VIG, VDIGX and JENSX - they dropped much less than SPY in the 2008 GFC. The higher quality of VIG, VDIGX and JENSX was responsible for their lower volatility because durably profitable company earnings are relatively predictable, allowing investors to price them without a lot of guesswork. VIG, VDIGX and JENSX outperformed SPY in only three, four and six years respectively, although they outperformed SPY over the ten year study period. SPY is the benchmark many investors use for investment comparison.



Annual Returns 2007 -2016										
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
SPY	5.14%	-36.81%	26.37%	15.06%	1.89%	15.99%	32.31%	13.46%	1.25%	12.00%
VIG	5.63%	-26.69%	19.57%	14.74%	6.16%	11.65%	28.87%	10.08%	-1.95%	11.97%
VDIGX	7.00%	-25.57%	21.74%	11.42%	9.43%	10.39%	31.53%	11.85%	2.62%	7.53%
JENSX	7.29%	-28.97%	28.98%	11.77%	-1.05%	13.54%	32.33%	11.72%	1.55%	12.01%

Source: Data from Morningstar, Inc.

So what?

We believe that the common denominator in VIG, VDIGX and JENSX is durable profitability. Durable profitability (quality) brings with it lower volatility than the market. What's not to like? With quality and low volatility we can get market-type returns with lower (less frenetic) volatility of our account balances. Will quality always outperform? Study says no, but investors in quality can rest peacefully that their investments won't crater in a serious downturn like weaker companies or lag much as stocks are climbing.

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