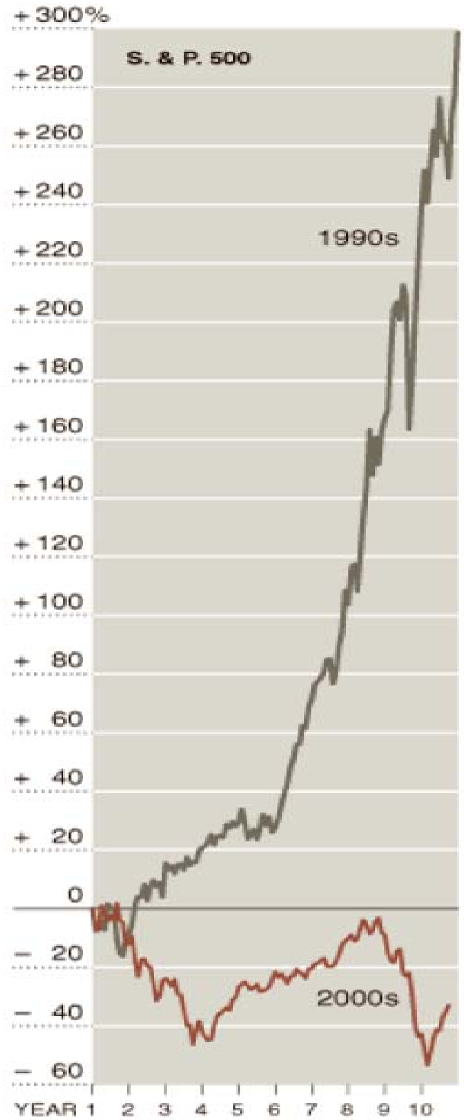
The S&P 500 Closes in on its Worst Decade Ever

The New York Times published a short article last week on how poorly the Standard & Poor's 500 index has performed over the last decade, concluding that for U.S. stock investors this will be the 'worst decade ever' (see chart at right). Individuals would have lost money investing in the S&P 500 index even if they were 'long term' investors.



The New York Times article concluded that investors would have come out far better over the last decade investing in 10-year treasury bonds, 6-month treasury bills, or even high yield corporate bonds. Bonds, as an asset class, soundly outperformed equities over the last ten years.

There are several important conclusions that can be drawn from the chart at right:

- The S&P 500 index is a major index of 500 of the largest and most successful companies and is used by many money managers, pension funds, and endowments as a benchmark. The fact that an investor in this index over the last decade would have lost money, while demands on pension funds and endowments have increased with inflation, will certainly add 'stress' to the financial system and will draw into question the appropriateness of this asset class (stocks) as a long term investment. It was no so long ago that stocks were considered an extremely risky asset class, one institutional investors utilized with caution.

- Most actively managed portfolios have not performed as well as the S&P 500 index after fees and expenses. This can be seen in the historical performance of actively managed mutual funds – most tend to lag the S&P 500 index. Again, the long term underperformance will raise questions as to the attractiveness of stocks as an asset class for investors.

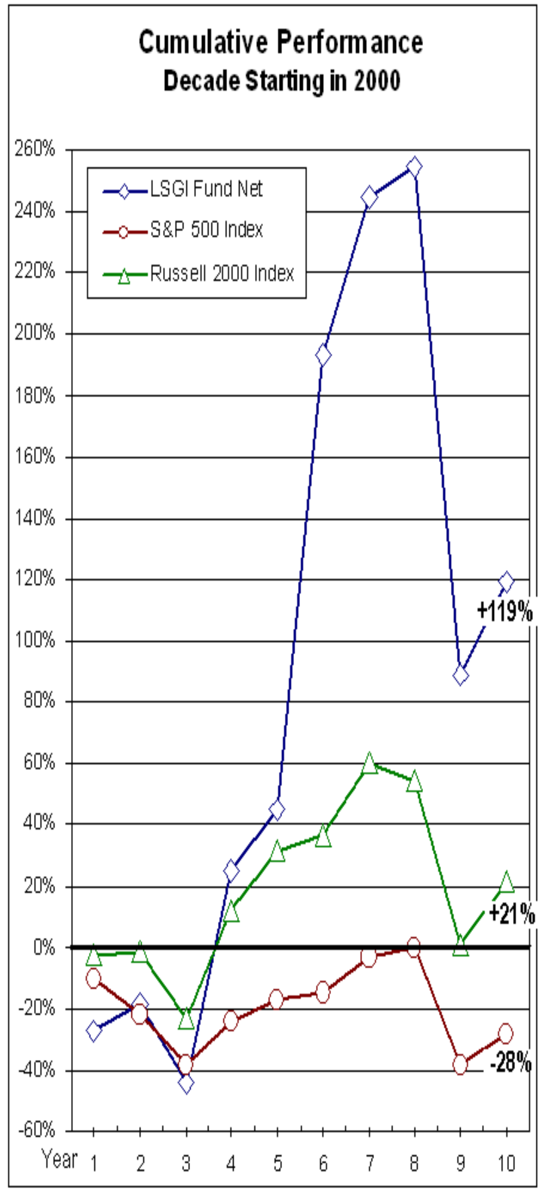
- While stocks performed very well in the 1990's (see chart at right) they have performed very poorly over the last decade. The concept of 'reversion to the mean' applies to the market – when stocks outperform long term averages for an extended period of time they tend to subsequently underperform, and vice versa. Over long periods of time the stock market generally returns roughly 7% per year, subject to volatile periods of over and under-performance.

We were a bit stunned at the New York Times chart, and how poorly the S&P 500 index has performed over the last decade. The policy and investment strategy implications could be substantial for many firms and investors.

While we are not pleased with the performance of the LSGI Fund over the last year, and year-to-date, we think our longer-term strategy to outperform the market is effective. To borrow a card game analogy while we may 'loose a few hands', over time our 'winning hands' will dominate.

Statistically, we have taken the attributes of firms that have historically outperformed and applied these factors in the current market to find attractive firms to invest in. We have been criticized that this is a mechanical approach, but it has generally served us well. It is a simple strategy, with historical statistical underpinnings, that tilts the odds of outperformance in our favor.

After reviewing the New York Times performance chart we constructed one of our own – but included the decade long performance of the Russell 2000 small capitalization index and the net returns of the LSGI Fund after all fees and expenses. We assumed that the year-end decade-ending valuations will be the same as the valuations on October 1st.



There are several conclusions that can be drawn from the chart at right:

- The market for smaller capitalization stocks represented by the Russell 2000 small cap index has performed much better in the last decade than the market for larger capitalization stocks. This is somewhat ironic, since most institutional investors, pension funds, individual investors, and endowments either ignore or seriously underweight the small cap sector in their portfolios in favor of larger companies.

- Micro-capitalization stocks, like the stocks we own in the LSGI portfolio, have performed much better than the market for larger stocks represented by the S&P 500 index.

- If we run our Capital Asset Pricing Model regression we find that over the last decade investors have received 'excess returns' in the LSGI Fund to the tune of 10.6% per year as compared to the Russell 2000 small cap index. The excess returns versus the S&P index are even larger (see chart).

- The LSGI Fund is roughly twice as volatile as the S&P 500 index and 1.8 times as volatile as the Russell 2000 index, reflecting the illiquid nature of the micro-cap market and our concentrated portfolio – as well as the pricing inefficiencies that exist in the small company market.

- The correlation of the annual returns of the LSGI Fund to the S&P 500 and the Russell 2000 indexes is very poor. Most of our excess returns are not explained by general market movements up or down. We think the excess returns in the LSGI Fund are due to the statistical nature of our stock selection techniques and our portfolio construction.