Stockbroker Economics and Overestimating Diversification

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by John Coumarianos

The English journalist and economist Andrew Smithers has called "stockbroker economics" the belief that all news is good news and stocks are always cheap. Advisors recognize the fallacy of that logic and rely on diversification to counter the inevitable asset-class volatility that markets deliver. But, according to many forecasts – including those from GMO – virtually all asset classes are likely to perform poorly over the next decade.

Portfolio diversification should give an investor exposure at all times to at least one asset class (and hopefully more) that's poised to do well. Of course, practically, that means usually having exposure to poorly performing asset classes too. But the theory, as advisors know well and explain to their clients on a daily basis, is that, with diversification, you'll damp volatility while enjoying decent returns over the long run.

To do well over a full cycle, however, you must purchase an asset class at a cheap price – or at least a reasonable one. It has to be priced to deliver good returns. And yet, most asset allocators prefer to avoid trying to value asset classes, viewing the exercise to be as pointless as index fans view the appraisal of individual stocks.

But viewing the exercise as pointless carries a contradiction. The same people who view asset class valuation as pointless often view stocks as perennially poised or priced to deliver strong, inflation-beating returns – which, of course, implies a valuation or return forecast. The contradiction is that one isn't avoiding asset class valuation if one thinks stocks are perennially priced to beat inflation by a handsome amount (say, "Siegel's constant" of 6.5%, real) and bonds are priced at least to keep up with inflation. One is merely defaulting to a naïve assertion.

Up until 2000, advisors had been able to engage in that contradiction without much worry. Since then, the S&P 500 has only delivered 4% or so annualized. But other asset classes have picked up the slack when stocks have faltered, vindicating widely diversified approaches to portfolio construction, if not simply "stocks for the long run."

But there's no law of finance that says that diversification must bail portfolios out when developed country stocks fail. There doesn't always have to be a few cheap asset classes. In fact, it isn't clear that any asset class currently offers compelling future returns, or that investors who diligently diversify will be rewarded for their discipline and efforts.

Asset class convergence

The financial crisis should have put doubt into advisors and consultants. Almost nothing performed well during that period except for U.S. Treasury bonds and agency mortgages, but almost everything performed well coming out of it except for emerging-markets stocks, which are down slightly.

Diversification didn't help going into the crisis, and it hasn't hurt coming out.

The second half of that observation comforts advisors, but it should also frighten them. After dropping simultaneously, asset classes have risen at once. And that may mean they are all expensive.

Before examining likely future asset class returns, it's important to revisit the technology boom and bust because that's the last time diversification worked well. Understandably, it's also the story about diversification advisors are eager to tell – perhaps too eager.

Diversification pays off during the tech bust

During the climax of the technology boom, the Shiller PE (price relative to the past 10-years real average earnings) of the S&P 500 reached its all-time high of 44. The ensuing decade was predictably unkind to the index, as it produced just under a 1% annualized return. Appropriately, it is often called the "lost decade" for stocks – or at least U.S. large-cap stocks.

But in their mania for large-cap technology stocks, investors neglected other parts of the stock market and other asset

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classes. Small-cap and mid-cap stocks uninvolved in technology were forgotten. REITs – bricks-and-mortar with the prosaic collection of rent -- were the epitome of unfashionable, "old economy" stocks.

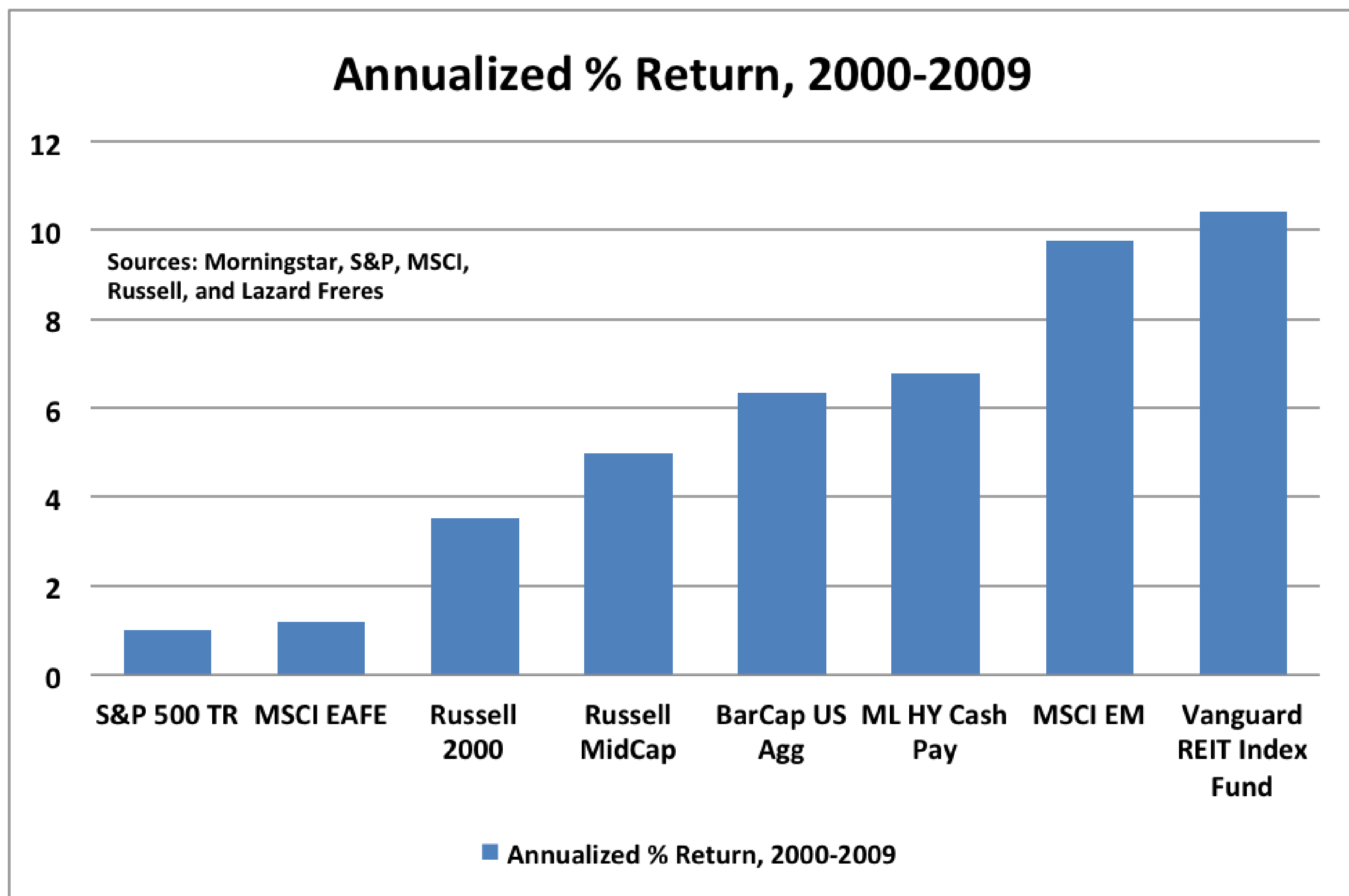
Emerging-market stocks, with their emphasis on energy and materials, were also orphaned. Pulling commodities out of the ground was so boring compared to software development and anything related to the Internet. These were the days when Fidelity rolled out Select Networking and Infrastructure and Select Wireless funds, only to shutter them both after 80%+ cumulative drops in the years after the bubble's peak.

Bonds also looked like they were suitable only for people deep into retirement, if anyone at all. Why waste your time with 5% when technology funds like Fidelity Aggressive Growth FDEGX (long since renamed) returned 103% and a slew of Janus funds returned over 70% in 1999? Even high-yield bonds seemed too tame to investors and, thus, were mostly forgotten.

In other words, almost everything besides developed country large-cap stocks and especially technology stocks was poised to deliver solid returns in 2000, and some asset classes were poised to deliver outstanding returns. Diversification away from U.S. and European large-caps paid off in spades. Anyone who had the courage to underweight the S&P 500, with its 44 Shiller PE, in 2000 could have chosen nearly anything else and justifiably felt vindicated at the end of the decade.

Misleading charts and "stockbroker economics"

The problem is that many are eager to spin a tale that diversification will pay off again. Therefore, charts like the following one proliferate on reports from asset managers and on the blogs and Twitter feeds of social media-savvy advisors.[i]



The problem with the chart is not that it's false. Those are the returns of those asset classes over that time frame. But it is misleading because, in addition to being a single random time frame, it has no reference to starting dividend yield and valuation for stocks or starting yield for bonds. It also gives the impression that because diversification worked starting in 2000, it can work again.

Therefore, the chart is a version of Smithers' stockbroker economics.

Developed country large cap stocks may not always be poised for strong returns. But, given how many other asset classes did well from 2000 through 2009, it's no wonder brokers, advisors and consultants use the chart to put prospects and

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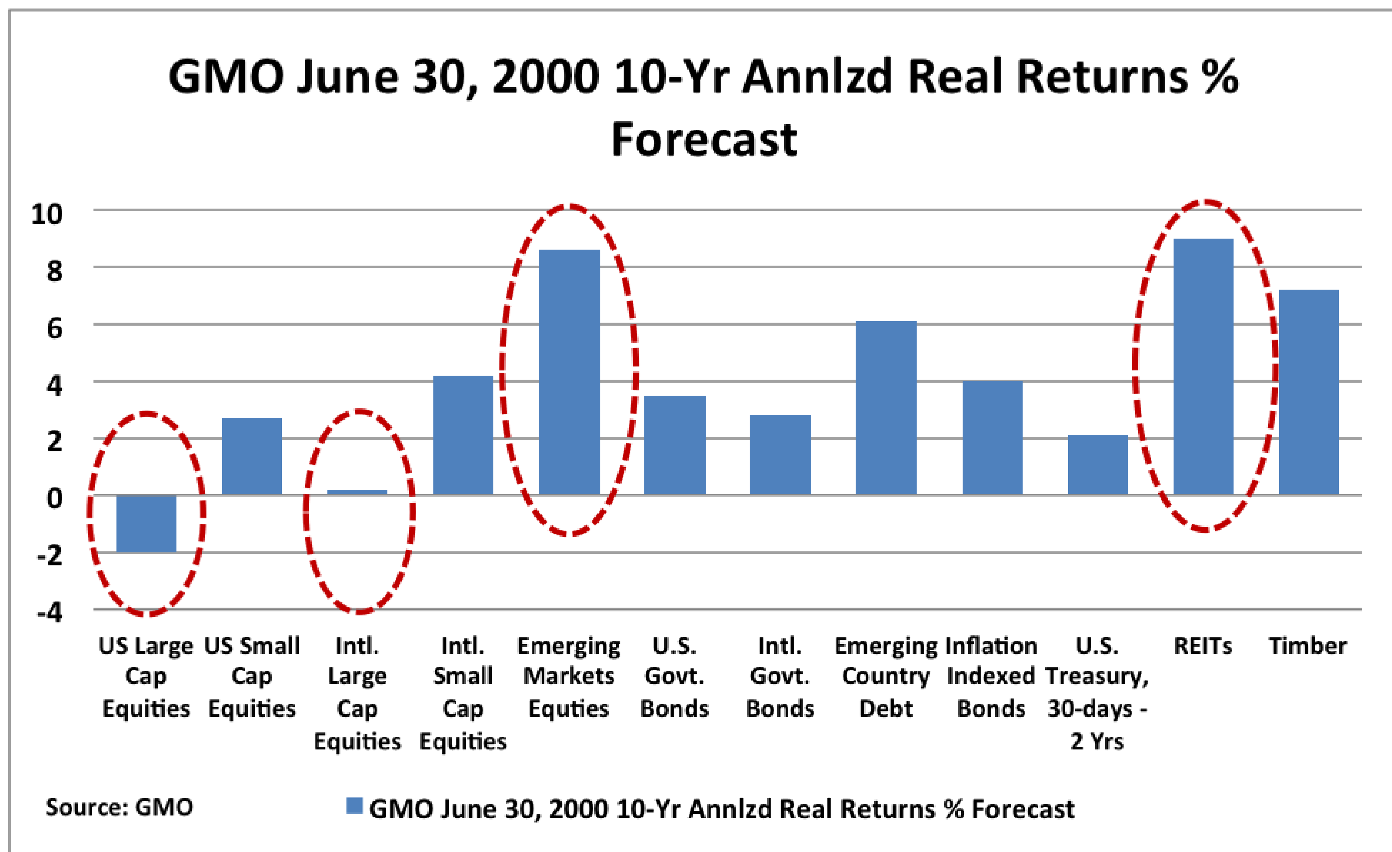
existing clients at ease.

GMO's 2000 forecast

In fact, it was possible to forecast what would do well in 2000, and it's possible to do so now as well.

A glance at Boston-based Grantham, Mayo, Van Otterloo's (GMO) June 30, 2000 forecast shows how successful the firm was.



GMO accurately forecasted the lackluster performance of U.S. and International large-cap stocks and the outperformance of REITs and emerging-markets stocks. Anyone invested in, say, a global balanced portfolio and trying to implement GMO's recommendations would have underweighted developed country large-cap stocks and overweighted emerging-markets stocks and REITs. Those would have been the correct moves to make.

GMO was correct in identifying the two worst performing (most expensively valued) asset classes and the two best performing (most cheaply valued) asset classes. (Keep in mind that the GMO forecasts are given in real terms. That means, when adjusted for inflation, the large-cap, emerging markets and REIT forecasts were impressively close to the actual outcome.)

For bonds, GMO begins with starting yield and an inflation estimate. For stocks, GMO relies heavily, though not exclusively, on the Shiller PE. Ben Inker, a portfolio manager at the firm, has said on conference calls that although the firm uses multiple factors for stocks, it would be satisfied being limited to the Shiller PE.

What's cheap now?

Having established GMO's success in 2000, here is its most current asset class forecast (as before, in real terms):

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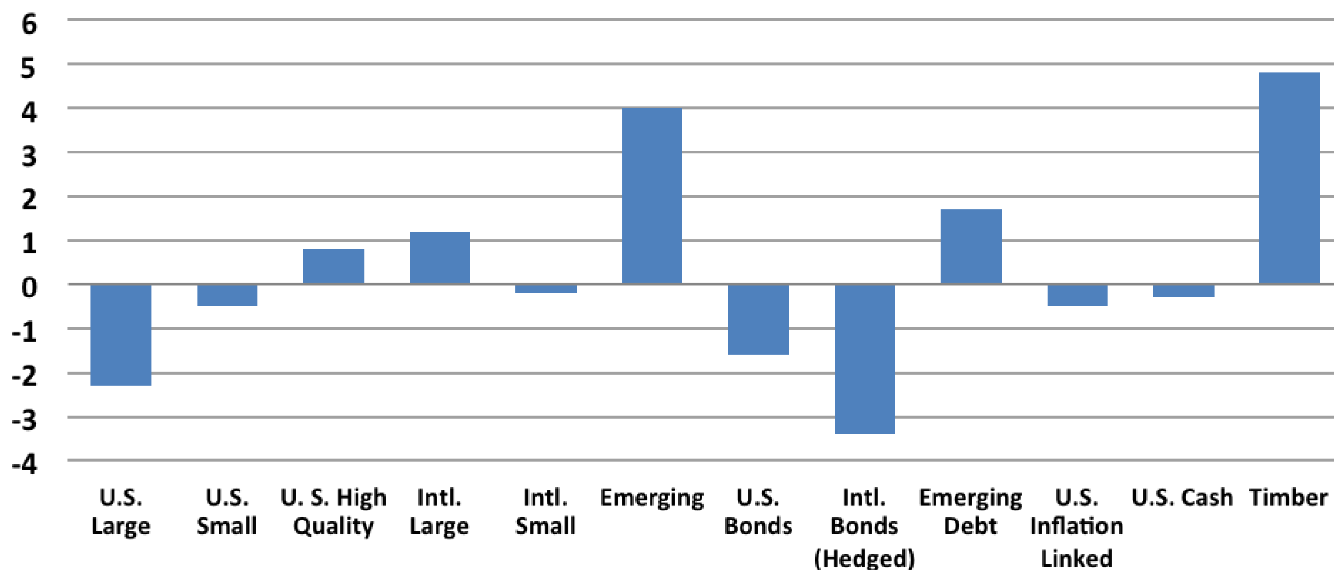

Nothing that ordinary investors can access easily (i.e., excluding timber) is poised to do particularly well, save emerging markets, with return assumptions applying to unhedged U.S. investors incurring the volatility of foreign currency. And even emerging markets equities are not likely to produce a 6%-7% real return, which many take to be the standard long-term historical equity return. Aside from timber, only U.S. high-quality, international large-cap, and emerging debt are forecast to eke out victories over inflation. All other asset classes, including U.S stocks (large and small) and developed-markets bonds, are unlikely to maintain pace with inflation.

Investors with widely diversified portfolios will be hard-pressed to merely keep pace with inflation over the next decade, never mind exceed it.

In other words, stockbroker economics is facing a serious challenge from GMO's forecast.

Two more views

So far I've concentrated on GMO's asset class forecasts. Let's look at two more to see if we get any variation.

First, Research Affiliates in Newport Beach, California, led by Robert Arnott, has a similarly dim view of U.S. stocks and bonds. Arnott doesn't have high hopes for REITs either, though they should do slightly better than the S&P 500. Where Arnott differs is on international socks – both developed and emerging. He thinks the MSCI EAFE will return more than 6%, real, annualized over the next decade, and emerging markets will return over 8% annualized.

If Arnott is correct, investors may have some hope if they significantly overweight international stocks in their portfolios.

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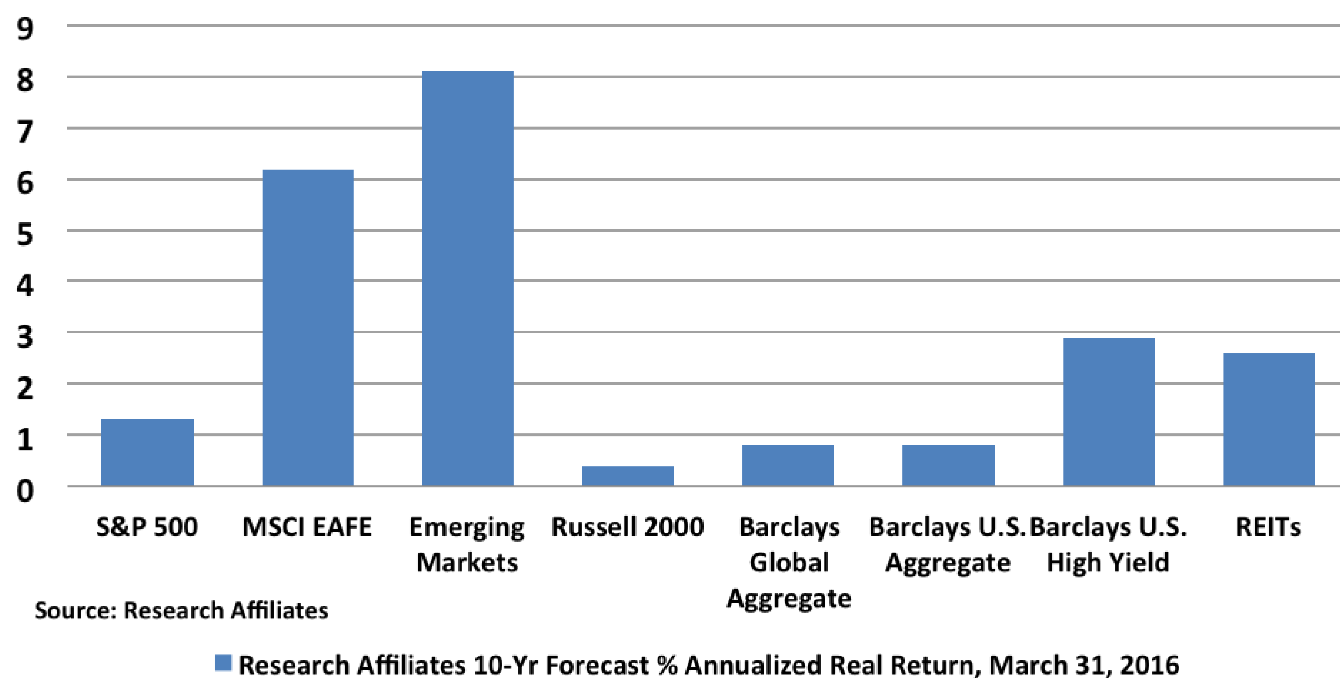

Last, Jack Bogle gave an interview to Morningstar's Christine Benz in late 2015, where he surmised U.S. stocks would return 4% (or 2% after inflation) over the next decade. Unlike GMO and Research Affiliates, both of which rely on the Shiller PE among other things, Bogle based his forecasts on a starting dividend yield of 2%, future growth of around 5%, and multiple contraction from 20 to 15 for -3%. Bogle uses a one-year trailing earnings multiple.

Bogle also forecasted a 3% nominal return for U.S. bonds, provided investors skew their portfolios away from Treasuries and toward corporate bonds.

In other words, Bogle thinks balanced portfolio investors may squeeze out 1.5%-2% real returns over the next decade. Factor in advisor fees and bad trading, and a negative real return may be the result.

Bogle gave no forecast for international stocks and has been quoted before as saying investors don't need exposure to them given the revenues and earnings that American firms derive from foreign countries.

Conclusion

GMO's forecast is more pessimistic than Arnott's, and so is Jack Bogle's given his avoidance of foreign stocks. But it will be hard for investors to beat inflation by a solid margin, if at all, over the next decade. If Research Affiliates is correct, investors could have a fighting chance by investing almost exclusively in foreign stocks. Otherwise, all other asset classes are priced to deliver poor returns -- both relative to inflation and in what almost everyone would consider absolute terms.

Brokers, advisors and consultants must confront the future returns question anew. They must contemplate future returns as part of ordinary financial planning. As Morningstar's Benz says:

> *Forecasting the market's long-term returns, meanwhile, is. . . . arguably a necessary [exercise]. After all, users of even the most rudimentary financial calculators are called upon to enter what they expect their portfolios to return over their holding periods, right alongside their current savings, future contributions, and time horizons.*

Stockbroker economics – all news is good news, and stocks are always cheap – will never go away. But brokers, advisors and consultants who refuse to confront the likely returns from current bond yields and stock valuations will look awfully foolish in a decade.

John Coumarianos is a freelance writer. He has worked as a branch representative at Fidelity Investments, a mutual fund and equity analyst at Morningstar and a writer at Capital Group. He also runs the website/blog Institutional Imperative.

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[i] See, for example, Ben Carlson, "Mean Reversion from the Lost Decade," *A Wealth of Common Sense*, April 19, 2016.

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