Investment Lessons from the Past 92 Years Include Risk Management for Baby Boomers

- 75 million Baby Boomers are all in the Risk Zone, a time when they should be protected from losses.
- The U.S. stock market has soared more than 250% over the past 9 years.
- The U.S. stock market in 2017 was a story of reversals. Winners in 2017 were 2016's losers, and vice versa.
- For a change, foreign stock markets performed somewhat better than the U.S. in 2017.
- The U.S. stock market is the biggest in the world, but U.S. GDP has been edged out by China.
- In the perspective of the past 92 years, the past 5 years has provided the best stock returns for the risk. It has the highest Sharpe ratio.
- The 18 years from 1982 to 1999 delivered a whopping 1,970% return
- Conclusion: Boomer Power.

Study the past if you would define the future. — Confucius

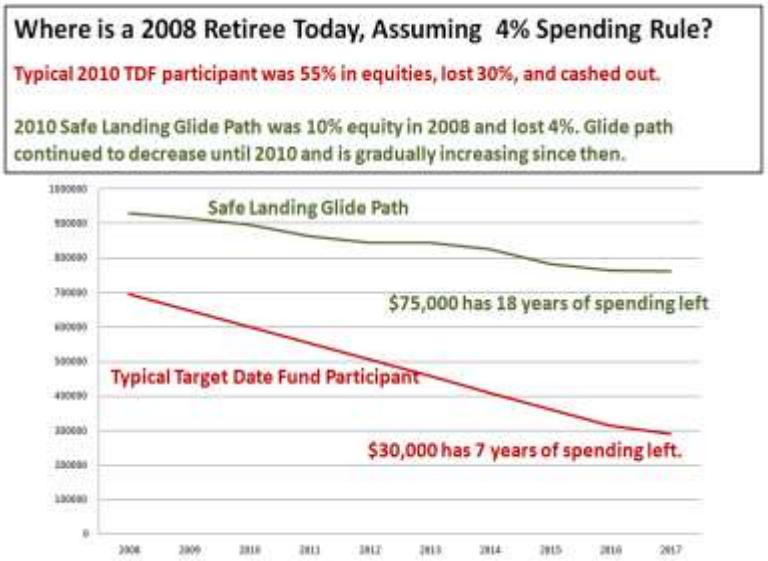
As is our custom, this end of year commentary reviews the past year and then expands your perspective to our full market history going back to 1926, 92 years. In addition to important lessons, you'll find valuable graphics you can use in client meetings. Many find our annual commentary serves as a great reference throughout the year.

But before we discuss the past, we have an important warning about the current Baby Boomer situation.

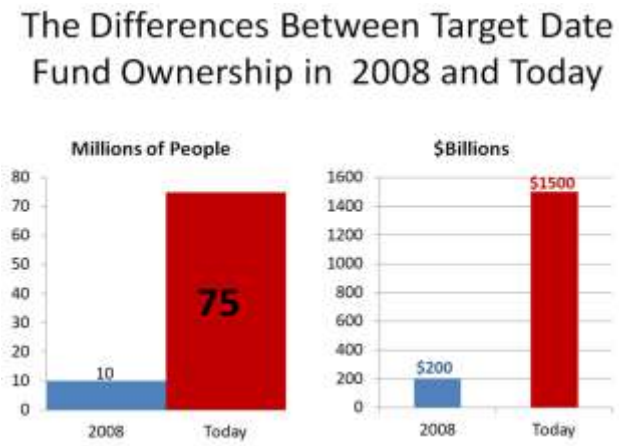
We All Lose if Boomers Lose

75 million Baby Boomers are at a stage in their lives when they should play it safe, but they are not because they trust others to make their risk decision, namely fiduciaries. They desperately need real risk management. Please see *$30 Trillion in Boomer Savings Needs Protection: The Next Market Meltdown Will Bring Lawsuits*.

Baby Boomers are all currently in the Risk Zone that spans the transition from working life to retirement. Losses sustained in the Risk Zone sacrifice lifestyles, even if markets subsequently recover. Most Boomers are unaware of this danger and are taking way too much risk. It's a Bad Gamble.



Target date funds (TDFs) lost 30% in 2008 and devastated those near retirement even though the belief is that they have since recovered. Most participants in TDFs withdraw their accounts when they retire and it's reasonable to assume that, having been burned, they put their savings in the bank. As shown in this graph, these typical participants have about 7 years of spending left in their TDF balance, assuming they are using the standard 4% withdrawal rule. By contrast, if they were protected by a TDF that uses the patented Safe Landing Glide Path®, they have about 18 years of spending left today.



The next market meltdown will bring class action lawsuits because TDFs have become riskier since 2008 and there is much more at stake now, as shown in the graph. The exposure to loss is NOT different this time, but its consequences are. We help you provide the risk management you need and deserve with our **Age Sage Robo for Boomers & Adults** and The Most Prudent Target Date Fund on the planet.

The Recent Past

With the exceptions of a couple slight stumbles in 2011 and 2015, the 2008 market correction has been followed by consistent market gains, with 2017 delivering a 22% total market return. It's been a nine-peat: nine straight years of solid market gains. The U.S. stock market has returned a compound 15.5% per year over the past 9 years, well exceeding the market's 10% per year average. On a cumulative basis, the US stock market has grown more than 250%.

But folding in 2008's 38% loss leaves us with a "paltry" 125% 10-year cumulative return, or 8.5% per year, somewhat below the market's 10% average nominal return. But the real (net of inflation) return for the decade is 7%, which matches the long term average real return. It's been an average decade in terms of real returns.

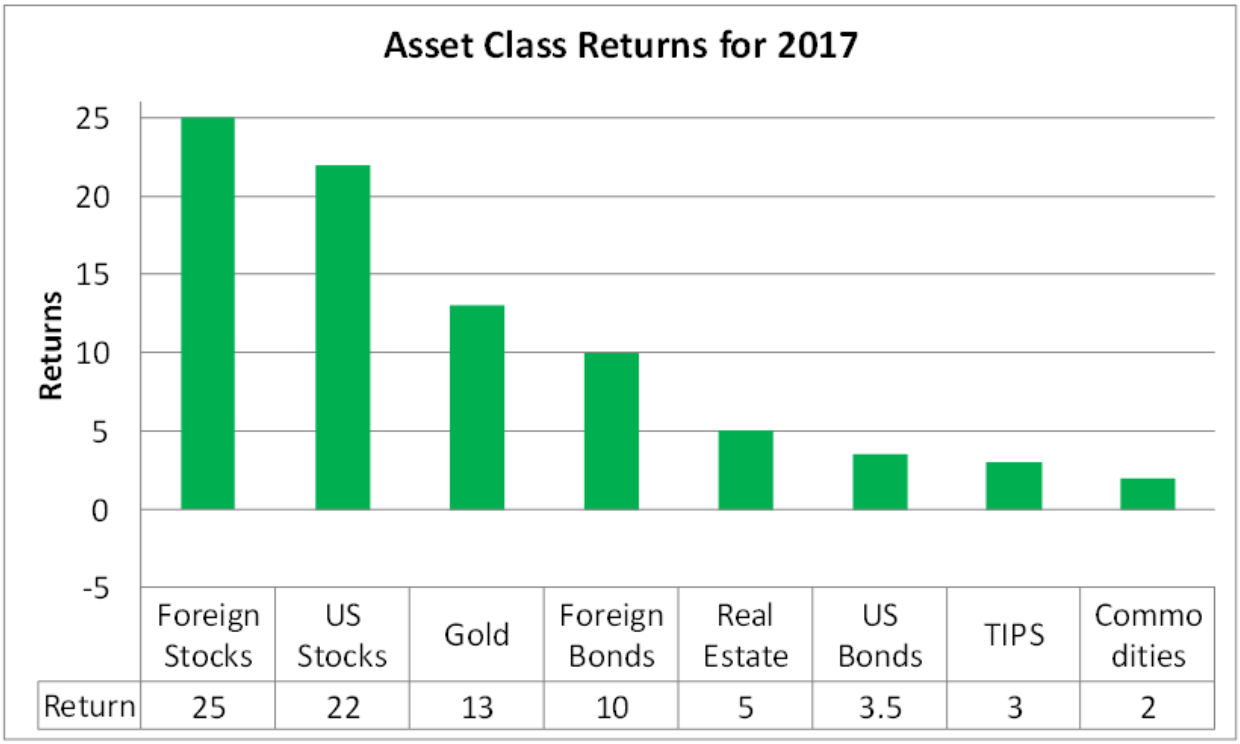
Some look at the past 9 years and say we're due for a correction while others look at the past 10 years and say we still have room for more. In both cases, the time frame is too short to make a meaningful guess. What we know for sure is that bond markets are being manipulated to offer no return, so investors are driven to stocks, and so far this risk has been rewarded. It's a $5 trillion experiment that has never been run before.

See the section below on the past 92 years for a longer term perspective and an observation that may surprise you..

In the next sections we look at diversifying asset class performance in 2017, and then examine US and foreign stock markets performance in detail.

America the Second Most Beautiful

The US stock market performed second best in 2017, a ranking that happened only once before in the past 8 years. Foreign stock markets performed the best in 2017. As is usually the case, there is a wide dispersion of performance in 2017 among multi-asset portfolios caused by varying diversification effects.



Source: The Capital Spectator

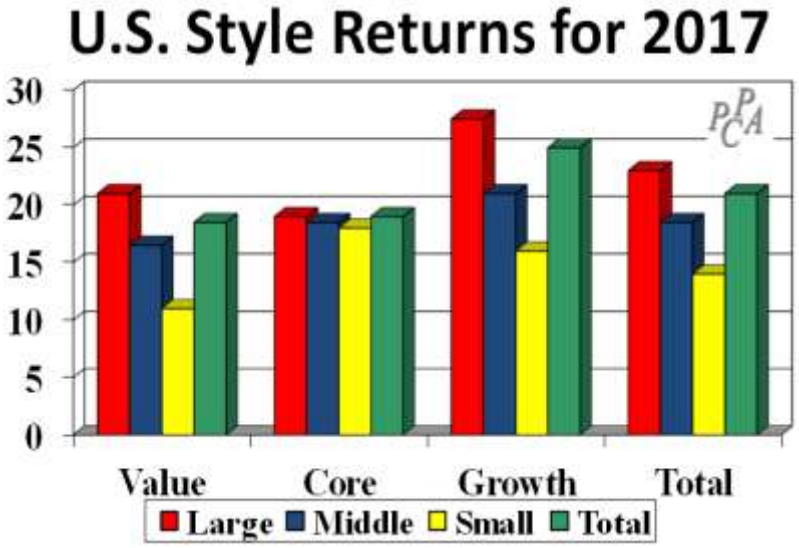
Diversification into foreign stocks helped performance, but diversification into commodities and U.S. bonds hurt. As is characteristic of reversals in 2017, commodities were the second best performing asset class in 2016 with a 12% return, coming in just behind U.S. stocks with a 13% return.

U.S. stocks have generally outperformed foreign companies in each of the last 8

years as shown in the graph on the right. Home has been the place to be.

In the following we examine the performance of US and foreign markets in 2017.

Winners and Losers in 2017



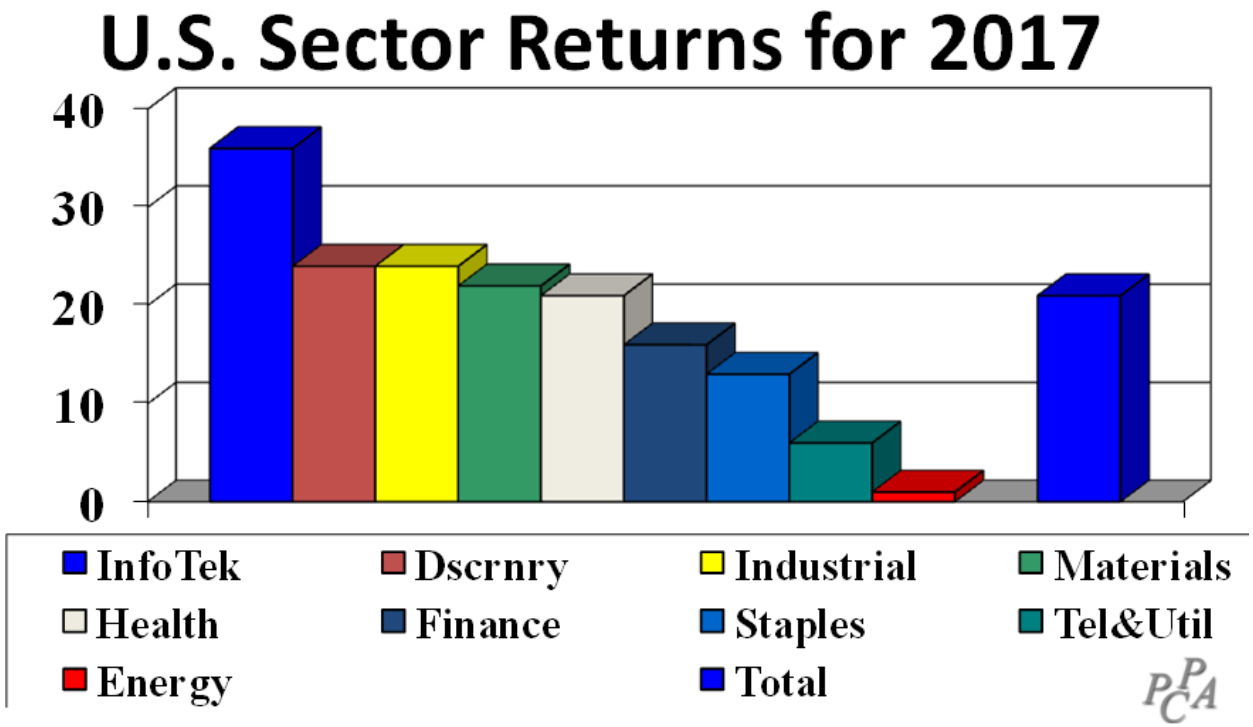
U.S. stocks

Reversing the relationships in 2016, large cap growth stocks led the way in 2017 while small cap value stocks lagged. Large-cap growth stocks earned 27% while small-cap value companies earned only 11%. I use Surz Style Pure® classifications throughout this commentary.

In our end-of-2016 commentary we attributed much of the success in smaller company value stocks to the popularity of "smart beta" that tilts toward smaller companies and value. Smart beta strategies had attracted more than $500 billion, which is about 20% of all US exchange -traded product. Our opinion was that the stampede was petering out, and it did.

For further perspective, here are the Russell and S&P Index returns for 2017:

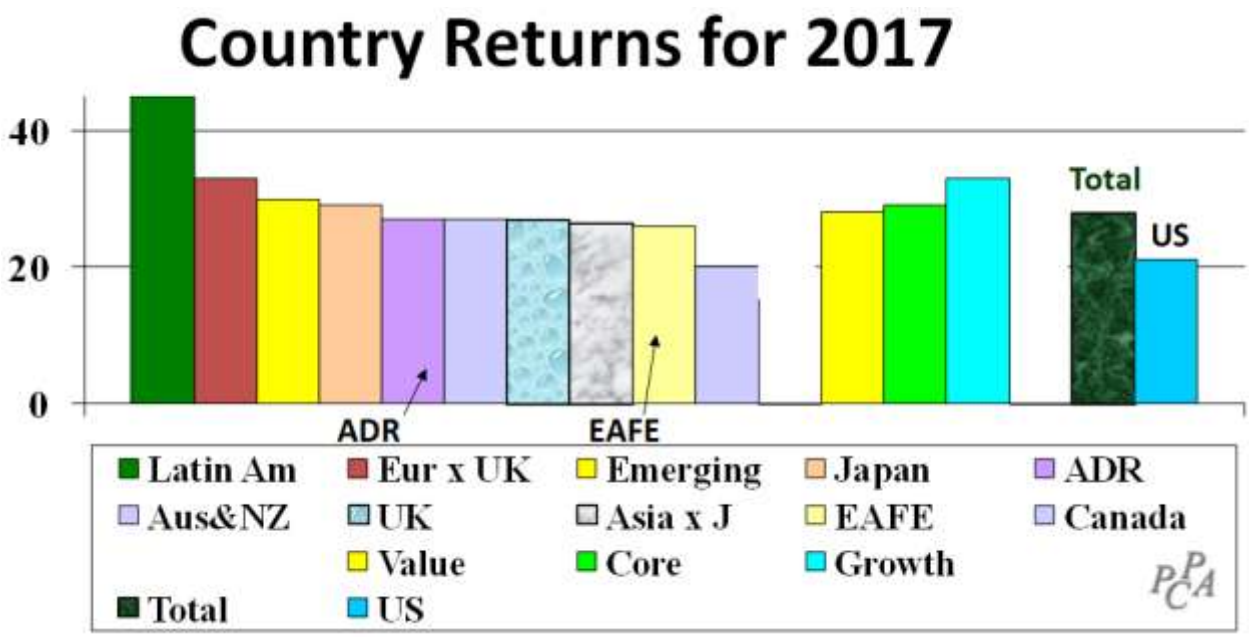
On the sector front, last year's winners became this year's losers and last year's losers became this year's winners. Energy stocks fared worst, earning 1%, while InfoTech led with a 36% return.



Foreign stocks

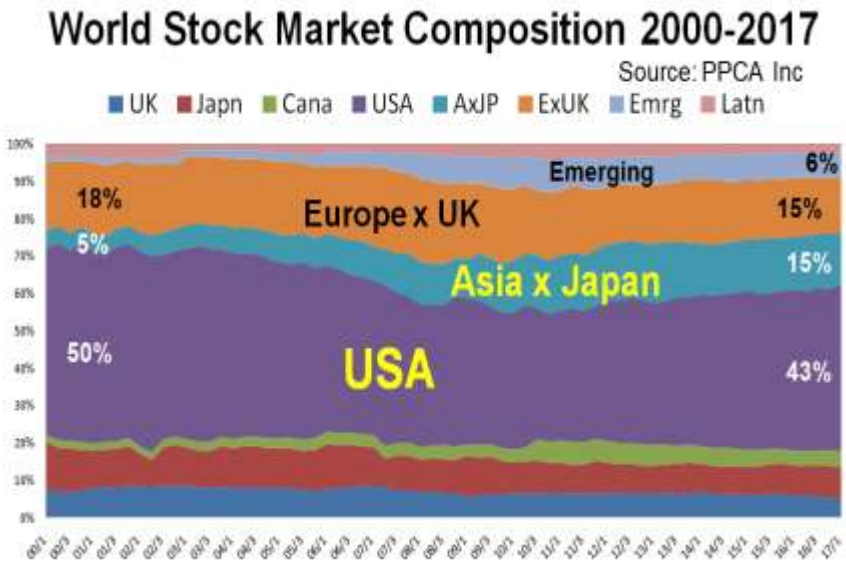
Looking outside the U.S., foreign markets earned 28%% in 2017, beating the U.S. stock market's 21% return, and exceeding EAFE's 26% return. Latin America, which is not in the EAFE, was the best performing region with a 45% return.

On the style front, growth stocks performed best with a 37% return while value stocks lagged with a 28% return.



Mirror mirror on the wall, who is the biggest of them all?

As comes as no surprise, the U.S. stock market is the largest in the world, although its share has decreased from 50% in 2000 to 43% today. During these 18 years Emerging markets and Asia, namely China, have garnered increasing market shares. The world is changing, ever so gradually.

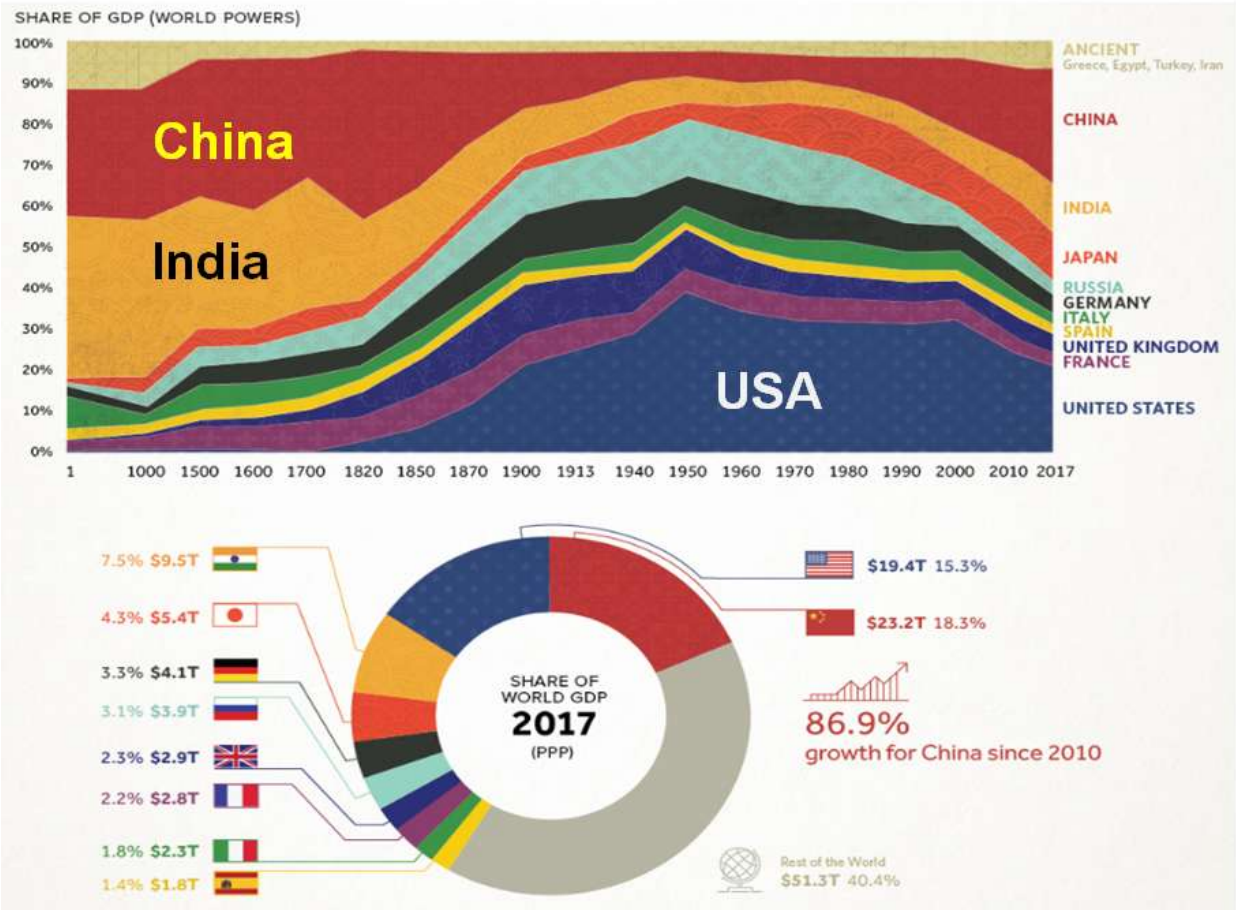


What may be a surprise to you is that the U.S. is not the most productive. The GDP of China has surpassed the U.S., as shown in the following:

Courtesy of: Visual Capitalist

2,000 Years of Economic History in One Chart

All Major Powers Compared By GDP From The Year 1 AD



The U.S. isn't the relative economic powerhouse it used to be. Time will tell where this leads.

The Distant Past: 1926-2017

The 92-year history of the U.S. capital markets

The table below shows the history of risk and return for stocks (S&P 500), bonds (Barclays Aggregate), T-bills and inflation. There are many lessons in this table, so it's worth your time and effort to review these results. For example, here are a few of the lessons:

1. The past 5 years has provided the best stock returns for the risk. It has the highest Sharpe ratio at 1.67% return per unit of risk, which is 5 times the average Sharpe ratio of .35%. It's been spectacular.

2. T-bill returns have exceeded inflation by only 0.4% per year over the full 92-year history, earning 3.39% per year versus inflation of 2.93%. Most asset allocation models assume a 1% premium.. The past 10 years has inflation exceeding T-bills by more than 1% per year. T-bills earned .28% versus inflation at 1.55%. We've been paying the government to use its mattress.

3. Bonds were more "efficient," delivering more returns per unit of risk than stocks in the first 46 years, but they have been about as efficient in the most recent 46 years. The Sharpe ratio for bonds is .48 versus .34 for stocks in the first 46 years, but the Sharpe ratio for bonds in the recent 46 years is .32, which is somewhat less than stocks at .37.

4. Stock returns for the past decade (2008-2017) are below average in nominal terms but near average in real (net of inflation) terms. The nominal return is 8.53% and the real return is 6.98%.

5. Despite recently low levels of inflation, average inflation in the past 46 years has been more than twice that of the previous 46 years: 1.99% in 1926-1971 versus 4.8% in 1972-2017.

6. Bonds returned 2.5% above inflation in the first 46 years, and that increased to 3.8% in the past 46 years.

7. The 4% standard deviation of monthly stock returns in 2017 is about one-fifth of the historical average of 18.68%. It was a "very quiet" year, with all 12 months in the plus column. It was a great year.

MARKET HISTORY FOR YEARS ENDING DECEMBER, 2017

	stocks			bonds			t-bills		cpi	
	RETURN	STNDEV	SHARPE	RETURN	STNDEV	SHARPE	RETURN	STNDEV	RETURN	STNDEV
2017-2017(1 YRS)	21.83	3.92	5.62	3.60	1.57	1.88	0.16	0.02	1.80	0.78
1926-2017(92 YRS)	10.16	18.68	0.35	6.04	7.22	0.36	3.39	0.89	2.93	1.80
1926-1971(46 YRS)	9.72	21.76	0.35	4.31	4.70	0.48	1.99	0.53	1.86	2.16
1972-2017(46 YRS)	10.61	15.01	0.37	7.80	9.03	0.32	4.80	1.00	4.01	1.27

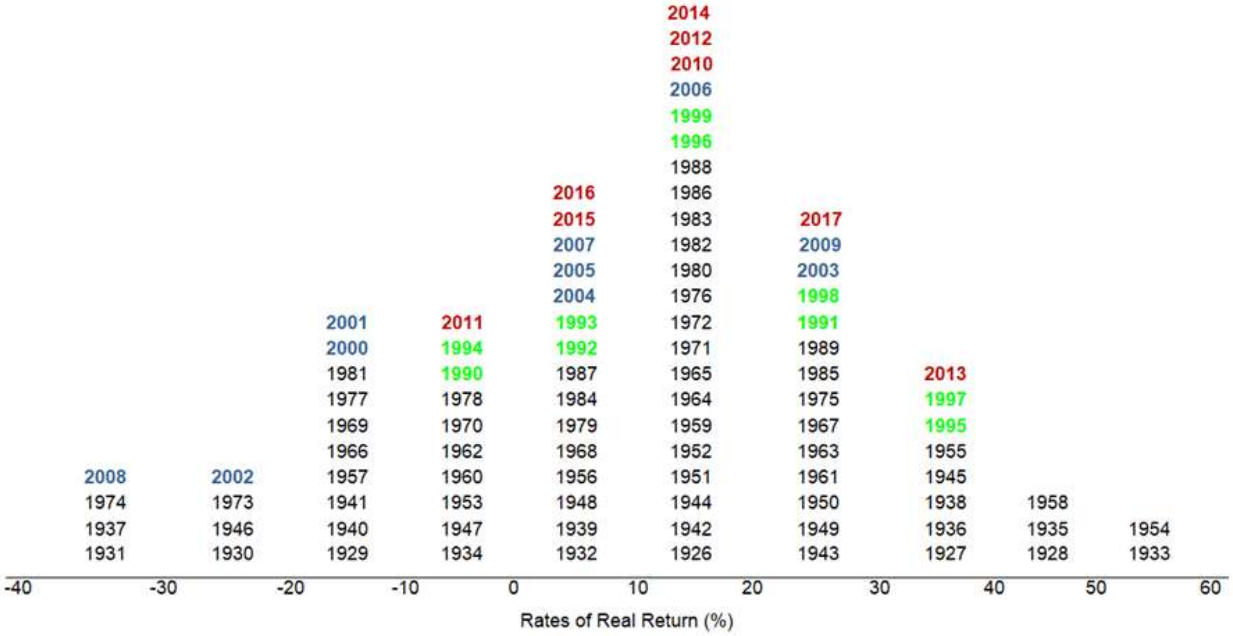
1928-1937(10 YRS)	0.02	36.23	-0.04	7.59	4.65	1.29	1.34	0.49	-1.77	2.54
1938-1947(10 YRS)	9.62	21.18	0.44	3.77	2.18	1.62	0.21	0.06	4.98	2.95
1948-1957(10 YRS)	16.43	13.21	1.10	3.03	5.23	0.27	1.61	0.21	1.95	1.56
1958-1967(10 YRS)	12.85	11.35	0.83	1.86	3.98	-0.31	3.15	0.30	1.78	0.64
1968-1977(10 YRS)	3.60	15.61	-0.13	6.07	8.07	0.04	5.74	0.39	6.24	0.97
1978-1987(10 YRS)	15.25	16.96	0.32	9.72	13.01	0.03	9.22	0.80	6.40	1.38
1988-1997(10 YRS)	18.04	12.05	0.98	10.17	6.10	0.71	5.63	0.53	3.46	0.62
1998-2007(10 YRS)	5.95	14.81	0.15	6.72	6.89	0.42	3.70	0.49	2.82	1.02
2008-2017(10 YRS)	8.53	15.08	0.54	5.50	9.40	0.55	0.28	0.15	1.55	1.38
1928-1932(5 YRS)	-12.47	40.71	-0.36	4.44	4.46	0.42	2.48	0.52	-5.42	2.18
1933-1937(5 YRS)	14.29	31.10	0.45	10.84	4.71	2.25	0.22	0.06	2.01	2.43
1938-1942(5 YRS)	4.62	26.75	0.17	5.40	2.48	2.15	0.05	0.05	3.21	2.25
1943-1947(5 YRS)	14.85	13.70	1.05	2.17	1.74	1.02	0.37	0.03	6.77	3.47
1948-1952(5 YRS)	19.37	13.08	1.37	2.06	2.61	0.31	1.25	0.10	2.65	2.01
1953-1957(5 YRS)	13.57	13.40	0.84	4.01	6.95	0.29	1.97	0.24	1.27	0.91
1958-1962(5 YRS)	13.31	12.80	0.83	3.45	3.77	0.27	2.40	0.24	1.33	0.67
1963-1967(5 YRS)	12.38	9.78	0.83	0.30	4.17	-0.83	3.90	0.18	2.23	0.59
1968-1972(5 YRS)	7.54	13.77	0.15	5.85	8.00	0.07	5.30	0.35	4.61	0.56
1973-1977(5 YRS)	-0.20	17.30	-0.35	6.29	8.21	0.01	6.18	0.39	7.89	1.09
1978-1982(5 YRS)	14.05	16.07	0.18	5.83	15.34	-0.30	10.79	0.85	9.46	1.38
1983-1987(5 YRS)	16.47	17.94	0.46	13.74	10.21	0.56	7.67	0.48	3.43	0.75
1988-1992(5 YRS)	15.88	13.36	0.65	12.13	6.33	0.82	6.61	0.58	4.17	0.72
1993-1997(5 YRS)	20.25	10.67	1.41	8.25	5.87	0.59	4.66	0.29	2.76	0.43
1998-2002(5 YRS)	-0.55	19.05	-0.25	8.29	4.70	0.81	4.34	0.43	2.51	0.69
2003-2007(5 YRS)	12.87	8.61	1.10	5.17	8.56	0.24	3.06	0.49	3.13	1.27
2008-2012(5 YRS)	1.53	19.02	0.06	8.48	12.90	0.62	0.43	0.21	1.68	1.68
2013-2017(5 YRS)	16.01	9.52	1.67	2.60	3.21	0.77	0.13	0.02	1.42	1.02

Additional perspective is provided by the following histograms of stock and bond returns.

92-Year Return History for Common Stocks (Adjusted for Inflation)

1926-2017

Average Annually Compounded Real Return = 7%

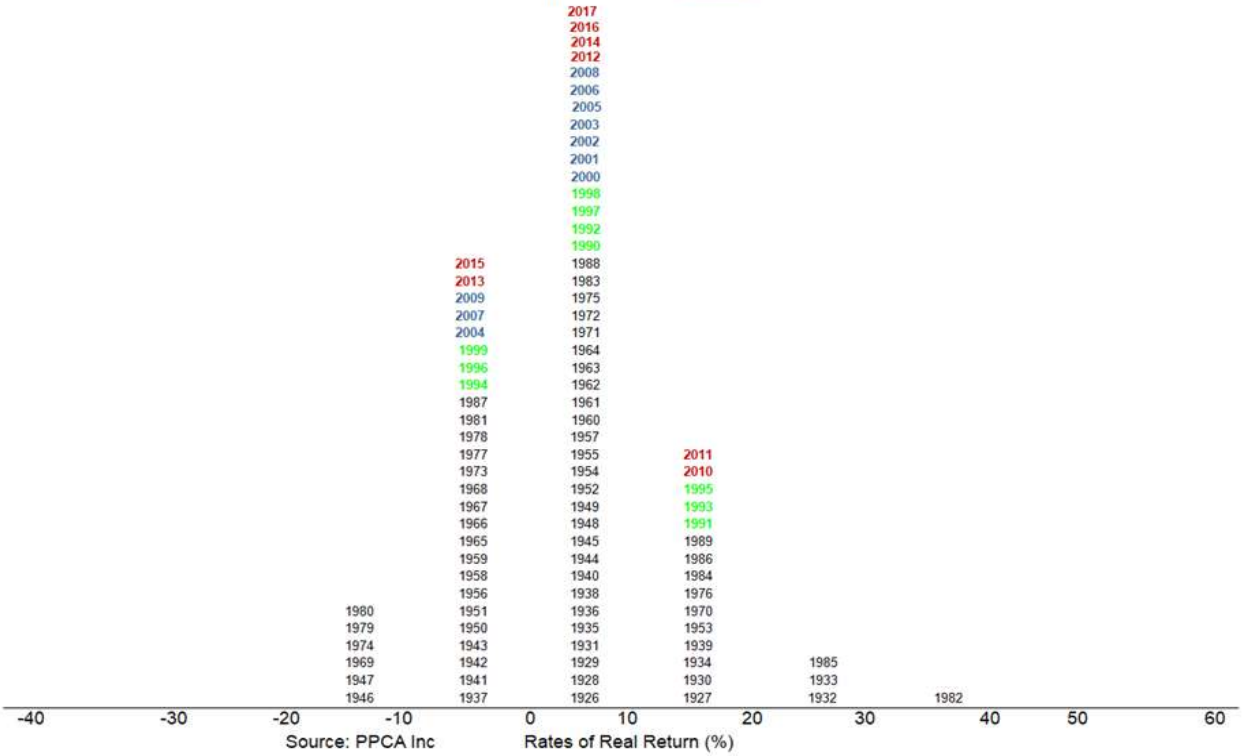


Source: PPCA Inc.

92-Year Return History of Long-Term Corporate Bonds

1926-2017

Average Annually Compounded Real Return = 3 %

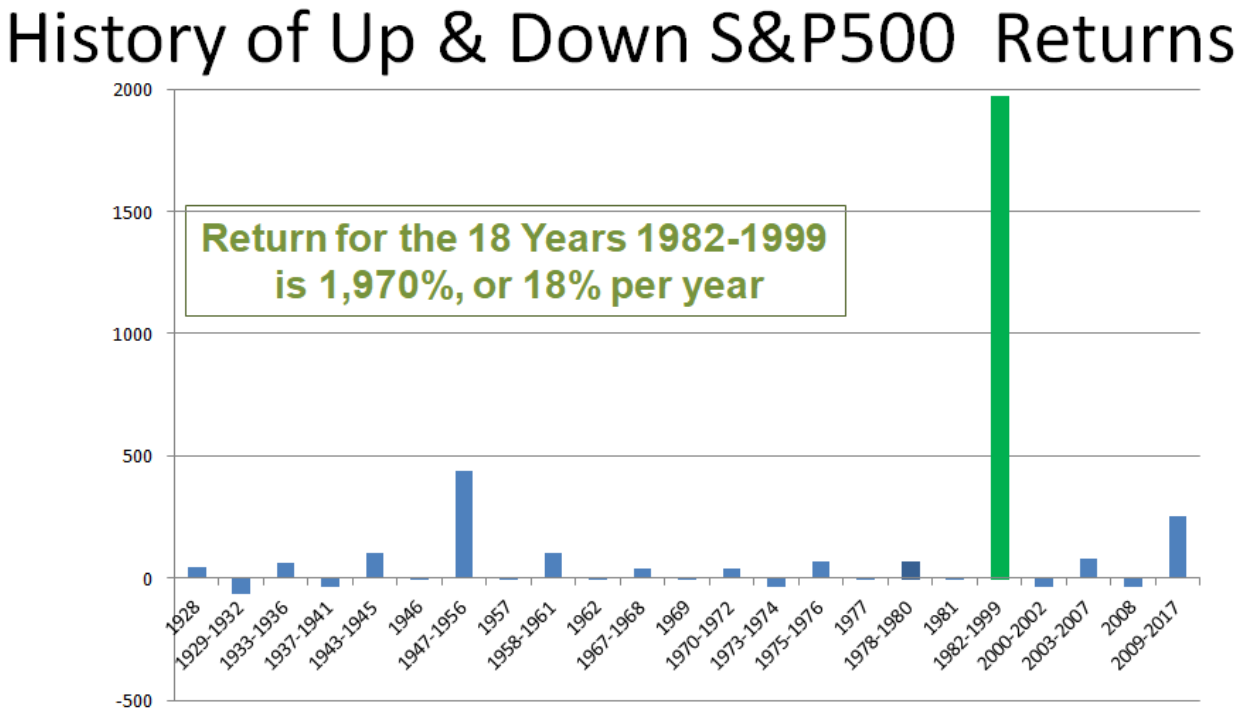


Source: PPCA Inc

When trees grew to the sky

As discussed earlier in this report many forecasts for 2018 are based on the past 9 or 10 years, but these are short periods of time. As shown in the following graph, U.S. stock markets had a phenomenal 18-year run from 1982-1999, earning 1,970%. Some of you will remember that the mantra in those days was "Trees can grow to the sky" because this time is different. It was the beginning of the technological revolution.

If you're looking for reversals, the years following 1999 are a good place to look. My eye tells me that there hasn't been much of a reversal, yet.



Source: Ben Carlson, Upside Risk Management

Conclusion

The past 9 years have been extraordinary in many ways. Bond markets have been manipulated to keep interest rates artificially low, deploying unprecedented $trillions of taxpayer money. This has stimulated actions that drive up stock prices. Corporations have bought back their own shares because their cost of capital is much less than the

borrowing rate. Most importantly, those who would prefer to invest safely cannot because we are paying the government to use their mattress. In particular, Baby Boomers have been driven to take stock market risk. If Boomers do sell a substantial part of their $30 trillion, as they should because they are in the Risk Zone, it will cause a market correction, so you don't want to be the last one out the door. If they don't sell, the next meltdown (whenever it occurs) will create a public outcry like the world has never heard. It will take 20 years for Boomers to pass through the Risk Zone, so there's a good chance of a correction in that time span.

Can Society support tens of millions of Broke Boomers? Will it? If Boomers lose, we all lose.

Ron Surz is President of PPCA Inc and its Target Date Solutions subsidiary that just launched the Age Sage Robo for Boomers &Adults.
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