O'Shaughnessy ASSET MANAGEMENT

Predicting the Markets of Tomorrow — An Update

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In my book *Predicting the Markets of Tomorrow*, I stated that the middle of the year 2000 marked the end of a momentous 20-year cycle where large capitalization growth stocks and indexes like the S&P 500 dominated the market with outstanding returns. I further stated that the new cycle, which began in the year 2000 would see small and mid-cap stocks and large capitalization value stocks go on to vastly outperform large-cap growth stocks and the S&P 500.

Using reversion to the mean as a guide, I made the following forecasts for the 20-year expected real (after inflation) rates of returns for the following indexes:

Index	**Real Compound Growth Rate** 01/01/1980–12/31/1999	**Forecasted Real Compound Growth Rate** 01/01/2000–12/31/2019
S&P 500	13.34%	3–5%
French Fama Large Growth	13.29%	1.97–3.97%
French Fama Large Value	12.53%	6.03–8.03%
Ibbotson Small Stocks	11.01%	7.6–9.6%

As you can see, we enjoyed phenomenal returns for the 20 years ending December 31, 1999, especially if you were invested in the S&P 500 or large capitalization growth stocks. But my expectations were especially grim for the S&P 500 and large-cap growth stocks for the next 20 years, with low single digit returns expected for both.

Grim New Decade for Large Growth and S&P 500

We are now nearly seven years into the new cycle, and it is time for an update. Here's how investors have fared with investments in each of the above indexes made on January 1, 2000 through October 31st, 2007:

Index	**Real Compound Return** 01/01/2000–10/31/2007	**$1 invested now worth**
S&P 500	-0.44%	$0.97
French Fama Large Growth	-4.34%	$0.73
French Fama Large Value	3.34%	$1.29
Ibbotson Small Stocks	9.25%	$2.00

Investors who learned the wrong lessons during the 1980s and 1990s and stuck with large-cap growth stocks and indexes like the S&P 500 have *lost* money over the last seven years after inflation is taken into account. Large-cap growth mavens will have to hope for an increase of nearly one-third in their portfolio's value simply to get back to breakeven! And ardent indexers in the S&P 500 have *nothing to show* for the last seven years! Meanwhile, investors who understood the new cycle favored small stocks and large-cap value stocks have done significantly better: an investment in small stocks has *doubled* an investor's money, even with the most vicious bear market since the 1970s occurring during the period. And more conservative investors who favored large-cap value stocks have seen their portfolios grow by nearly 30 percent.

It's difficult to overstate the differences in these returns: Imagine that your 401(k) had $100,000 in it as of January 1, 2000 and, like many investors, was invested in a variety of large-cap growth funds. As of October 31st, your portfolio's value would have shrunk to around $73,000 and you would be worrying about how many more years you would have to work before you could comfortably retire. Conversely, had you reallocated your portfolio to small-cap funds, your portfolio's value would have doubled and been worth around $200,000!

Now, this is *not* a suggestion that you should put all of your eggs in one basket, but rather a stark reminder that asset allocation really matters again and you should make investments based on where we are in the cycle. I continue to advocate the preferred portfolio allocation outlined in my book, with 50 percent of your equity portfolio in large-cap value stocks; 35 percent in small and mid-cap value and growth stocks and 15 percent in "classic" large-cap growth stocks. If you are able to use a strategy which includes value constraints in large-cap growth, you could increase your exposure to large-cap growth by following a "growth at a reasonable price" methodology.

I'm often asked "isn't the rally in small stocks over?" or "why allocate *anything* to large-cap growth if its expected returns are so low?" The answer to the first question is that while small-cap stocks might have a fallow few years digesting the gains of the last seven years, I still believe that through December 31, 2019 they will offer the highest real rates of return as they revert upward to their average real rate of return for all twenty-year periods of 10.42 percent. As to why invest in classic large-cap growth at all, there will inevitably be a few years over the next 13 years where large-cap growth names reignite the imagination and hopes of investors and turn in great returns. By following an intelligent asset allocation, you will have a small portion of your portfolio invested there to partake in those returns.

Change your Focus, Change your Future

What's more, investors who ask short-term questions like" isn't the small-stock rally over" are focusing on the wrong things. Evolution has been unkind to us in regard to investment success — nature has programmed us to be overly concerned with what is happening *right now* rather than at some distant point in the future. Unfortunately, short-term movements in the market are mostly random noise. You need to focus on much longer periods of time to see what to expect over the long-term. If you can overcome the desire to try and make decisions based on what's happening right now and can stick with a focus on where the long-term data suggests we are heading, you will be vastly better off come 2019. For now, the returns for the last seven years seem to be heading in the direction that the new cycle suggests will continue through 2019.

Investors should keep in mind that there is no certainty that any investment or strategy will be profitable or successful in achieving investment objectives. Past performance is not an indication of future results.

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