

ground to the S&P 500 in the 1980s and the bottom quartile gained ground, so the pattern repeated itself from the 1980s to the 1990s, and again from the 1990s to the decade ending in 2009. This latter comparison, however, does not present quite the same results as its predecessor, perhaps because the level of returns in the past decade was so low (in fact, about -1.5 percent). Nonetheless, the funds that clearly topped the S&P 500 by the largest margins during the 1990s fell behind into the 2000s, and those that fell furthest behind (-7.2 percent) shot up to a dramatic superiority ($+8.3$ percent) during the following decade. RTM to be sure, but perhaps an imperfect manifestation.

Figure 10.2, on the other hand, is indeed a perfect manifestation of RTM. When we compare equity funds with one another (rather than with the S&P 500), quartile by quartile—in truly incredible symmetry—the first shall be last and the last shall be first. The top funds moved from a 4.8 percentage point advantage to a 3.0 percentage point disadvantage, and the big losers moved from a 4.8 percent disadvantage to a 3.0 percentage point advantage. For the second quartile, the decline in relative return was *minus* 2.0 percentage points; for the third quartile, the same 2.0 percentage point margin, but on the plus side. While such a pattern of symmetry is obviously unlikely to repeat, there can be little doubt that mutual fund champions come down to earth with remarkable consistency.

Gravity and Stock Market Sectors

Large-cap growth and value funds must provide short-term returns that roughly track those of the stock market before costs are deducted. But over the long run, because of costs, they must fall significantly short. Should investors seeking superior long-term returns concentrate on stocks in selected *sectors* of the stock market that may have characteristics that lead to outperformance? Alas, there seems to be no enduring systematic bias in favor of a particular market sector. RTM seems

consistently to turn even what often appear to be long-term secular trends into mere cyclical phenomena, albeit often of considerable duration.

Let's look at four examples: (1) growth stocks versus value stocks, (2) high-grade stocks versus low-priced stocks, (3) large-cap stocks versus small-cap stocks, and (4) U.S. stocks versus international stocks. The net result of all four examples (I tip my hand here) is that, in each of these key market sectors, RTM is alive and well.

Growth Stocks versus Value Stocks

We begin with growth stocks (generally, those with above-average earnings growth, price-earnings ratios, and market-book ratios) and value stocks (lower in each case, and offering above-average yields). For this study, I've examined 60 years of growth funds (mutual funds with stated growth objectives and a record of above-average volatility) and value funds (seeking both growth *and* income, and demonstrating average to below-average volatility).*

In recent years, the conventional wisdom has been to give the value philosophy accolades for superiority over the growth philosophy. Perhaps this belief predominates because so few observers have examined the full historical record. Nonetheless, over the long run, as shown in Figure 10.3, RTM proves powerful and profound. In the early years, growth funds controlled the game and were clearly the winners from 1937 through 1968. At the end of that long era, an investment in value stocks was worth just 62 percent of an equivalent initial investment in growth stocks. Value stocks then enjoyed a huge resurgence through 1976, redressing almost precisely the entire earlier deficit. (This recent history—covering only eight of the entire 60 years up to 1997—created the value stock mystique.) Then, growth stocks outperformed through 1980, and value stocks pretty much dominated through 1997. (As it happened—RTM at work again?—growth stocks returned with a fury to preeminence in 1998.)

*Before published industry norms for the two groups became available in 1968, I relied on a sample of funds whose objectives, portfolios, and annual returns made this distinction clear.

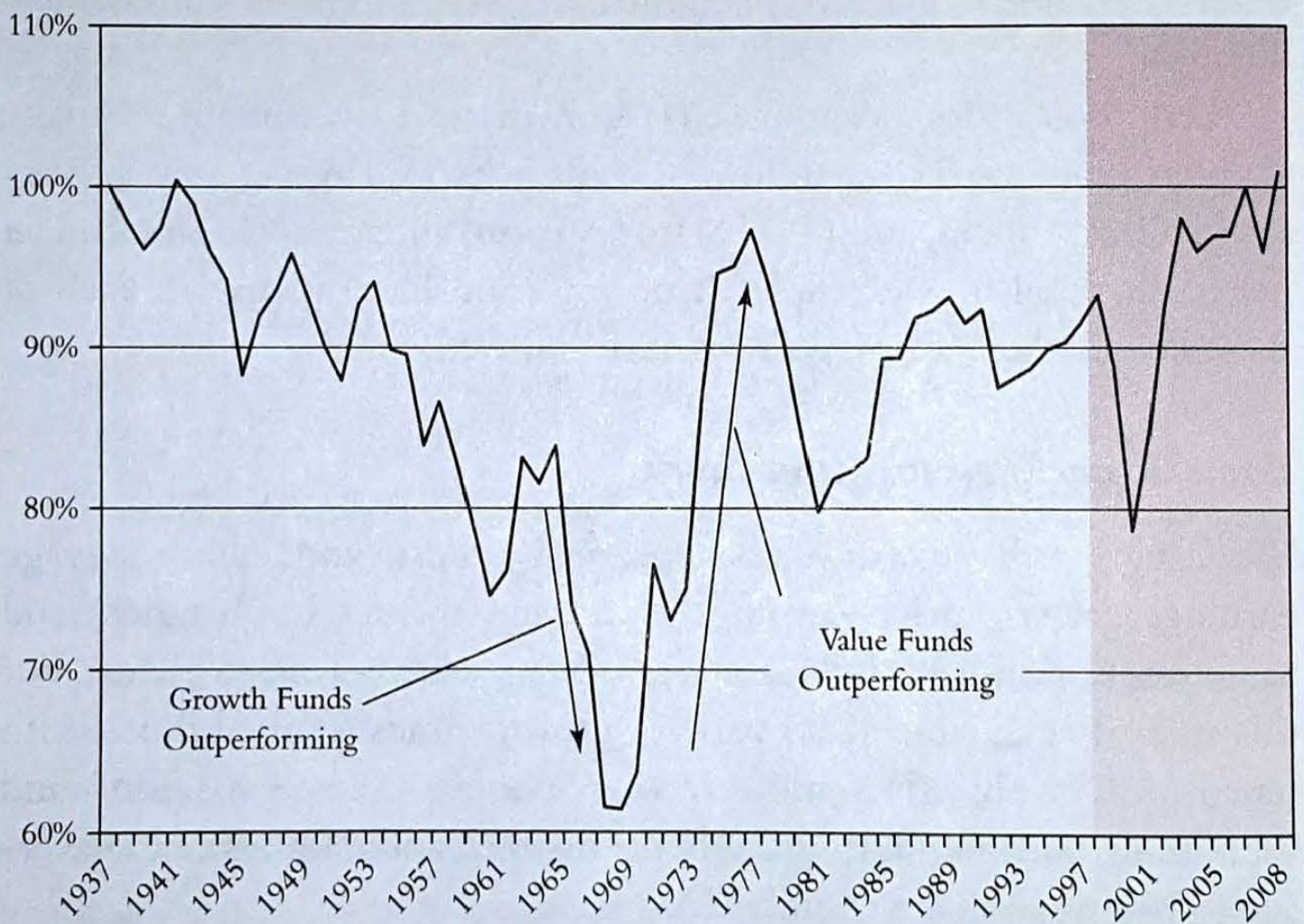
FIGURE 10.3 Growth Funds versus Value Funds (1937–2008)

FIGURE 10.4 High-Grade Stocks versus Low-Priced Stocks (1925–1995)

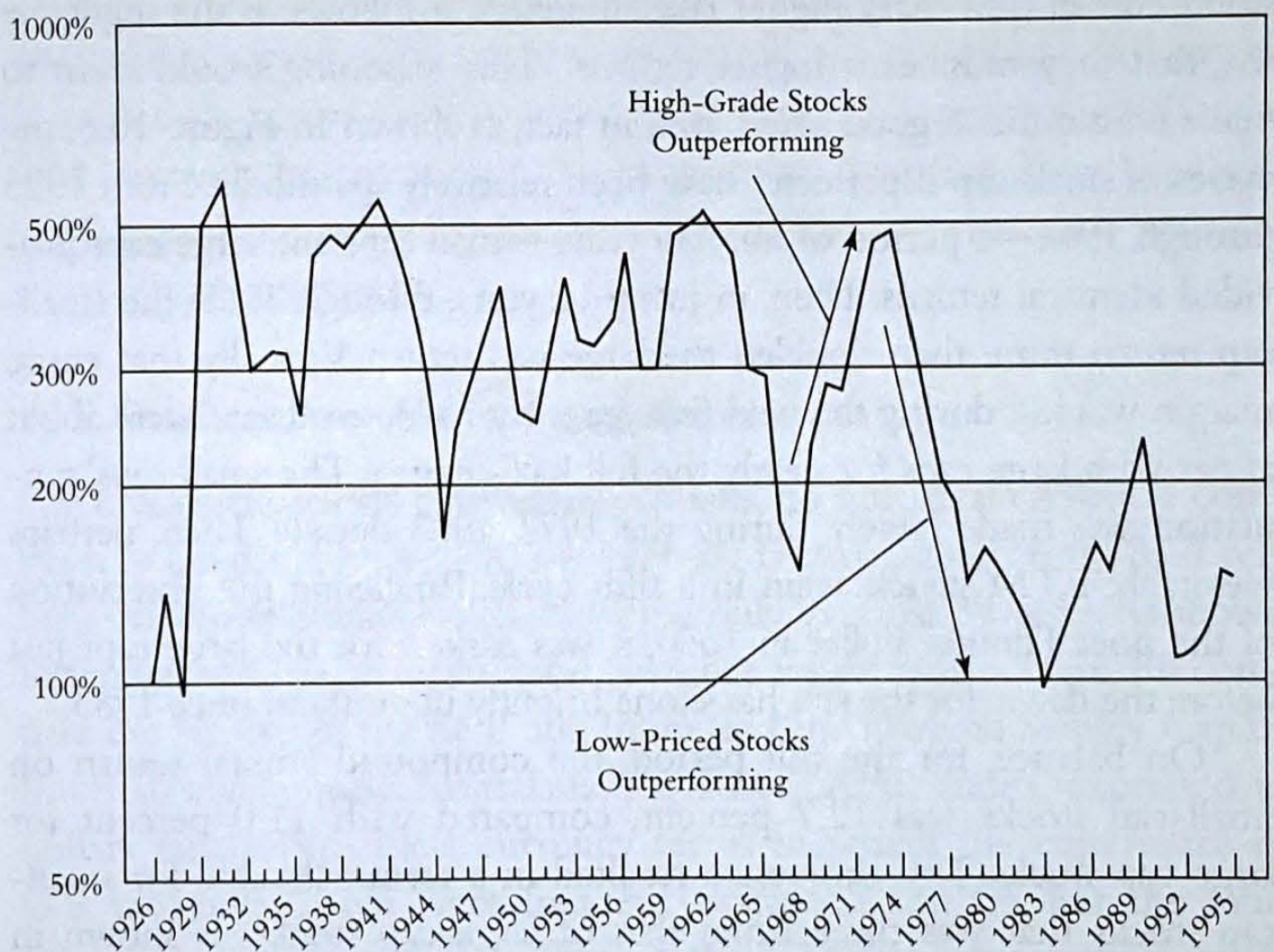


FIGURE 10.5 Large-Cap Stocks versus Small-Cap Stocks (1925–2008)

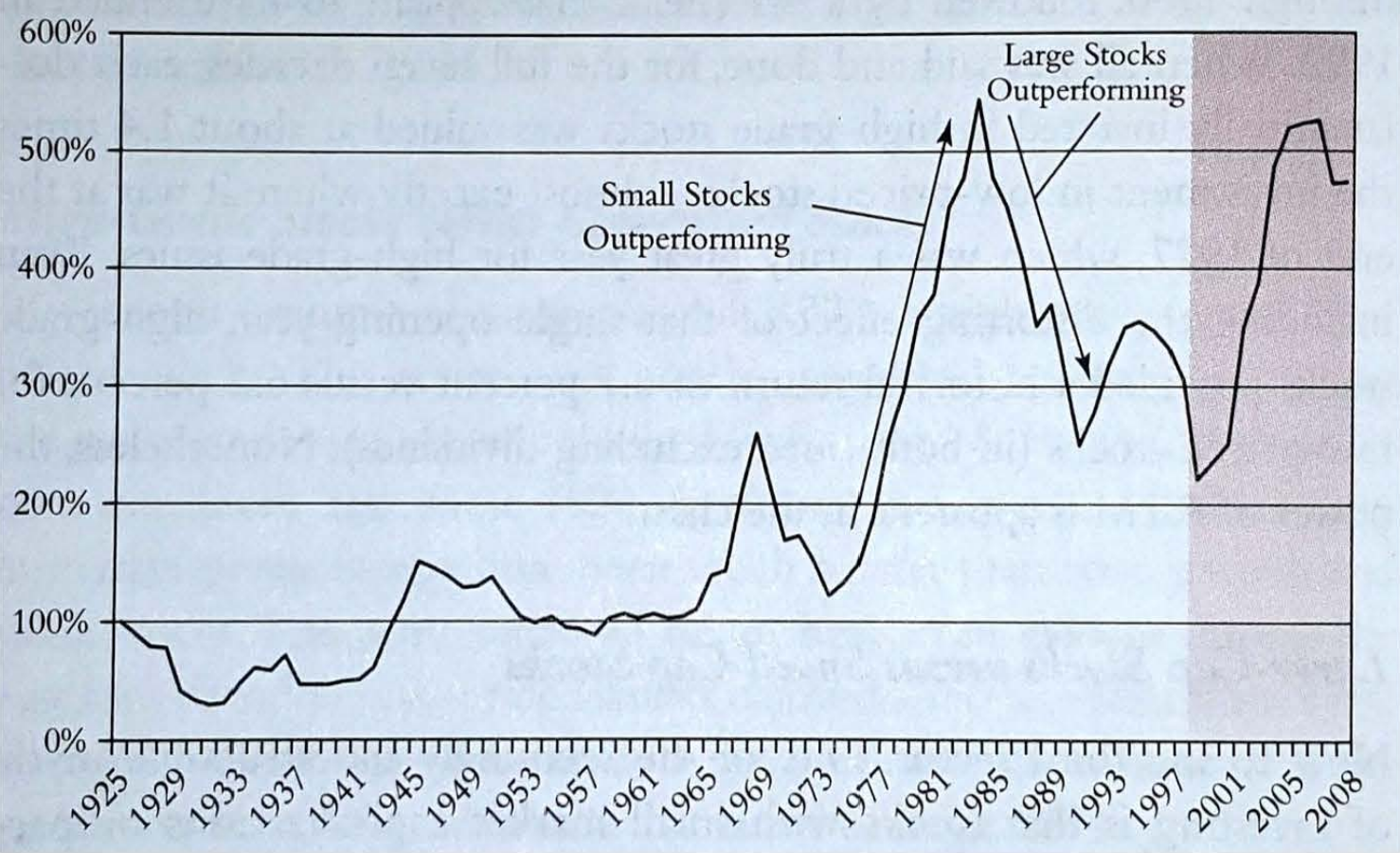
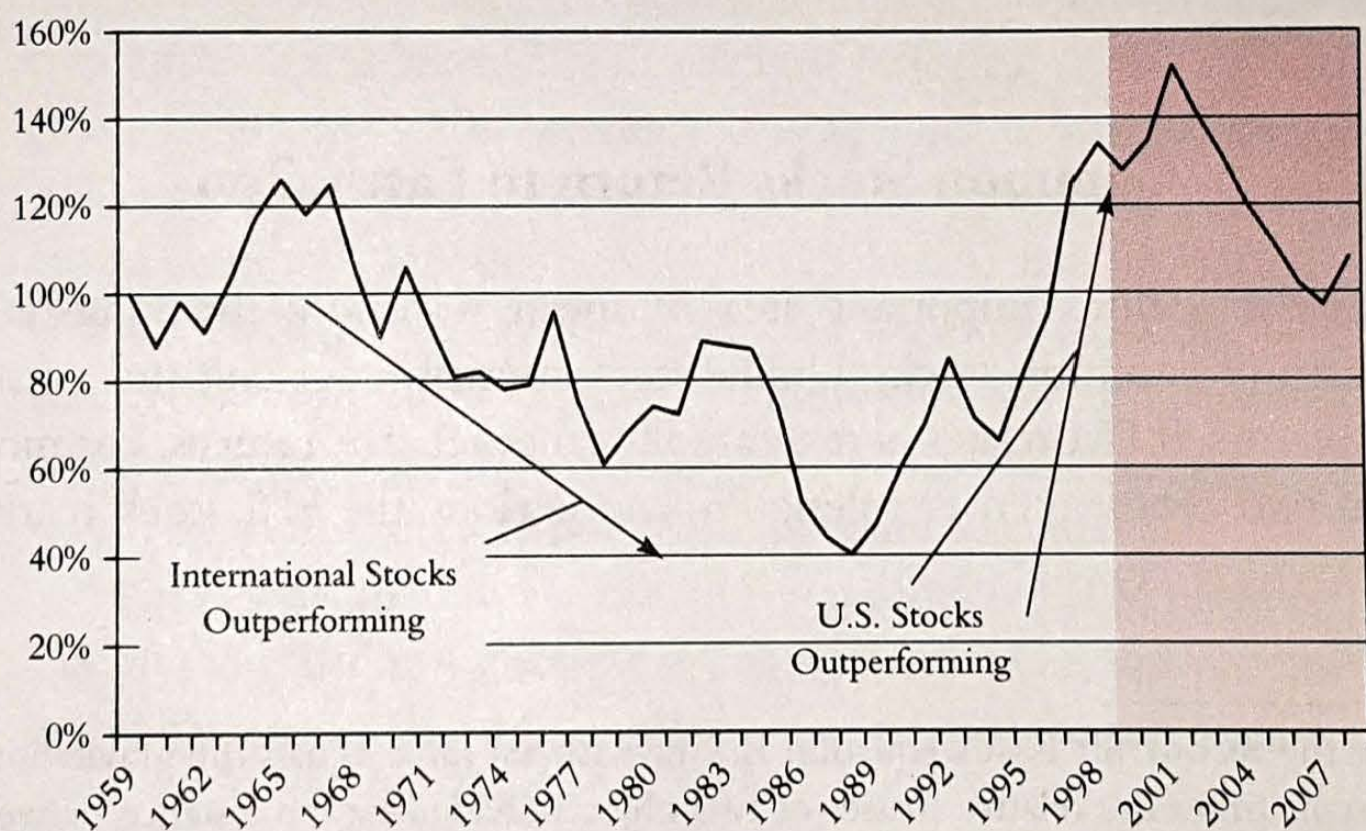


FIGURE 10.6 U.S. Stocks versus International Stocks (1959–2009)



TEN YEARS LATER



RTM in Stock Market Sectors

The RTM patterns illustrated in the previous edition—growth stocks versus value stocks, large-cap stocks versus small-cap stocks, and U.S. stocks versus international stocks—also continued during the past decade-plus. (Standard & Poor's Corporation no longer provides indexes for high-grade stocks and low-priced stocks.)

Growth funds, which had slightly lagged value funds during 1979 to 1995, soared past value funds during the great bull market that ended in 2000 (Figure 10.3). Then value quickly shot ahead during the next two years. The advantage changed hands often since then, but significantly, the average annual returns of the two categories during the 72-year period covered by Figure 10.3 were actually *identical*—9.7 percent for growth funds and 9.7 percent for value funds.

Large-cap stocks and small-cap stocks, too, continued their back-and-forth pattern (Figure 10.5). Large did better during 1994 to 1998; then small shot ahead during 1999 to 2006, with large doing better since then. While the small-cap advantage over large-caps is substantial in terms of historical annual return (13 percent versus 10.7 percent), it is significant that large-cap stocks at least held their own over incredibly long periods; for example, from 1945 through 1973 (28 years), and from 1982 through 2008 (26 years). Maybe the long-term historical pattern will persist—who really knows?—but investors who hold small-cap stocks disproportionately larger than their market weight would be well-advised to have a full measure of patience.

The past decade has also reflected—in spades!—RTM between U.S. and international stocks. The domination by U.S. stocks continued through 2001, only to see a major reversal (in part due to

(Continued)

the weakness of the U.S. dollar) through 2007. Then, in 2008, U.S. stocks held a slight advantage, followed by a slight disadvantage through mid-2009. Over the full half-century, the annual returns are virtually identical: U.S. 9.1 percent, international 9.0 percent. Investors who believe that they can time these reversions—so evident in Figure 10.6—are playing a dangerous game.

has demonstrated a profound tendency to provide real (after-inflation) returns that surround a norm of about 6.7 percent. As shown in Figure 10.7, the swings around this norm are reasonably narrow, and returns are much below 4 percent in only five periods.

In short, real returns have ranged between roughly 4 percent and 10 percent in 93 percent of the 25-year periods—a remarkable record of consistency. RTM is alive and well in the stock market. The standard deviation of annual returns in 25-year periods—about half of an investing lifetime for most investors today—is plus or minus 2.0 percent from the norm. In fairness, in a time frame of 10 years, the standard deviation is 4.4 percent; in an investment lifetime of 50 years, it is a minuscule 1.0 percent. Time horizon makes a meaningful difference.

The root cause of these consistent long-term returns is fundamental: corporate dividends and corporate earnings growth. And, using data we

FIGURE 10.7 Rolling 25-Year Real Stock Returns (1826–2008)

