2013: Biggest Rally in U.S. Stocks In 18 Years

Stocks of all sizes and shapes had a solid 4th quarter, and a great 2013. According to Morningstar, large cap growth stock funds led the quarter with a return of 11.83%. Value style funds, small and large cap, returned about 10.5%. Core funds returned 8.9% to 9.2%. Small cap growth stock funds returned 7.42%, but finished the year up almost 42%. Overall, U.S. stock funds were up 10.1% last quarter, and 33% for 2013. Stock funds outside the U.S. were up 4% to 5% for the quarter, and finished the year up 23% to 30%. Bond funds were down about ¼ of 1% last quarter, and down about 1.9% last year. Gold was down 9.4% last quarter, and down 27.8% in 2013, ending a 12 year run. As far as news headlines and economic data was concerned, the fourth quarter was somewhat quiet. The U.S. economy appears to be gathering some momentum. However, slow income growth and low levels of consumer spending should keep us on the path of slow growth, low inflation and slow tapering by the Federal Reserve. Workforce participation continues to drop; from 66.2% in 2006 to 63.3% last year. In 2014, I expect continued high volatility and more modest returns.

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Attractive investments outside equities were scarce in 2013.

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Now that the stocks have risen for 5 straight years, the inevitable investor response has begun: the reversal of investor cash flow. In 2013, investors withdrew $81.2 billion from bond funds, and put $162 billion into stock funds. Equity valuations and price/earnings ratios rose sharply in 2013, as investors were willing to spend more for the same $1.00 of corporate earnings. Historically, earnings growth drives stock prices up over longer periods. Last year, earnings growth and dividends were responsible for less than 10% of the U. S. stock market's overall 33% return. While I continue to believe that stocks will outperform bonds in the coming decade, I'm afraid that too much of this cash flow is just chasing recent performance. Unfortunately, some people put more time and effort into managing their fantasy sports teams than their retirement portfolios. A winning team requires talent and consistent performance at every position; don't "bet the season" (or your retirement income) on the last player to score. I do not have a Crystal Ball, but if I did it would tell me that investment gains make for a good offense, while avoiding large losses makes for a good defense.

How’s your Crystal Ball? In 1992, the Dow Jones Industrial Average finished the year at 3,301. Gas cost $1.05 per gallon. Bill Clinton was elected President. The U.S. Olympic Basketball “Dream Team” won the gold medal. Jack Nicholson said “You can’t handle the truth”, Tom Hanks said “There is no crying in baseball” and Rodney King said “Can we all just get along?” Did you know where the best and worst places to invest your money would be for the coming 22 years? Ibbotson Associates just updated their very popular chart, The Periodic Table of Returns. This chart tracks the performance of 10 major investment sectors, and a 60% equity/40% bond portfolio for each year from 1992 to 2013. As this chart proves every year, there is no single investment strategy that ensures a profit. The chart includes stocks: large and small, value and growth, U.S. and abroad. It also included real estate, bonds and commodities. Let’s see how some types of investors may have done over the last 22 years with $1,000.00 invested on 1/1/1992:

Ms. Crystal Ball: Always knew which would be the leading sector in the coming year, and moved 100% of her money into it. She turned $1,000 into $587,910.00! (P.S. Ms. Crystal Ball doesn’t exist; neither does any advisor who claims to consistently predict the winning investment sector every year.)

Mr. Most Exciting: Kept all of his money in emerging market stocks for 22 years. He made as much as 79% in some years, lost as much as 53% in other years. He finished first, and last six times each, placed in the top three categories 10 times, the bottom three nine times. After this wild ride, he finished with $5,993.00. I hope he did not try to retire in a down year.

Ms. Sensible Diversification: Her 60/40 portfolio grew to $5,890.00, and she probably slept better than Mr. Exciting. She only lost money in 4 of 22 years. Of course, to stay 60/40 required periodic rebalancing of her account.

Mr. Afraid-of-his-own-shadow: Remained 100% invested in investment grade bonds for the entire 22 years. He only lost money in 3 years, and although the last 22 years were better than average for bonds but he didn’t make very much. He finished with $3,560.00.

Ms. Performance Chaser: Every year, she moved 100% of her portfolio into the best performer from the prior year. She finished with $3,010.00. She would have made more money in bonds.

Mr. Consistently Wrong: Moved his money every year from the worst performing category into the following year’s worst performer. He finished with $706.00. He lost money in 15 of 22 years. As bad (and as impossible) as this is, he still couldn’t lose all of his money.

Will the next 22 years repeat the last 22? If we have higher inflation, bonds will do worse, and commodities will do better. Stocks will outperform bonds. No sector will win every year. Diversifying and periodically rebalancing your portfolio will still be the way to go. I can help you find a comfortable balance between portfolio performance and a good night’s sleep.

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The views and opinions expressed are those of Dennis Lynch as of 1/15/2014 and are subject to change based upon market conditions. Investment decisions should be based on an individual’s own goals, time horizon, and tolerance for risk. Past performance is not a guarantee of future results.

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