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The Art of Patient Investing

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Key takeaways

- **Diversification Benefits:** The extended period of outperformance by US stocks has led some investors to question the benefits of a diversified portfolio. Historically, diversification has proven to be crucial in investing by improving the risk-return tradeoff, smoothing out market fluctuations, and providing investors greater certainty about the range of potential returns.
- **Market Cycles:** Financial markets tend to move in cycles that can dramatically affect asset performance. The duration of such cycles can be painfully long. Diversification helps mitigate the risks associated with these cycles by not relying on specific market conditions.
- **Behavioral Biases:** Investors often suffer from biases like endpoint bias and performance chasing. Placing undue significance on recent events and extrapolating the recent past into the future can lead to poor investment decisions. Awareness of these biases can help investors make better choices.
- **Patience:** Patience is a virtue in investing, allowing investors to ride out volatility and benefit from the long-term growth potential of various asset classes. Investors who develop a long-term plan and stick with it will likely avoid the worst outcomes.

Introduction

In recent years, large cap US stocks and private equity have dramatically outperformed most asset classes. Almost every other asset class in a diversified portfolio has served as a drag on portfolio returns (see Figure 1). This is testing many investors' patience with diversification.

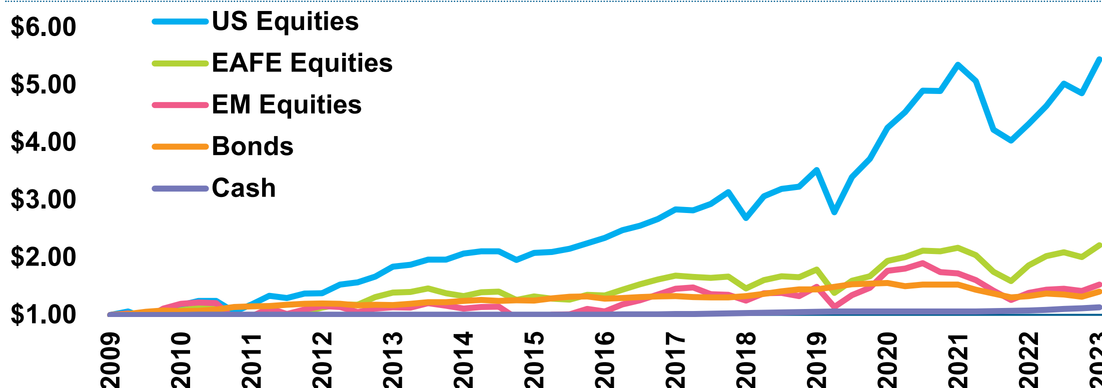

FIGURE 1
Growth of $1 Invested in Public Markets Since 2010

Represents the period from January 2010 through December 2023. Benchmarks used are as follows: Russell 3000 for US Equities, MSCI EAFE for EAFE Equities, MSCI EM for EM Equities, Bloomberg US Aggregate for Bonds, and Bloomberg 1-3 Month US T-Bills for cash.

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This research note is intended to remind investors of the benefits of taking a patient approach to investing. The first half focuses on the long-term case for a diversified portfolio. The second half explores various areas where investors may want to remain patient in the current market.

Part I: Diversification, endpoint bias, and patience

Diversification is often considered the only "free lunch" in investing. Diversification allows an investor to build a portfolio with a better expected risk-return tradeoff. The right combination of asset classes may smooth out the extreme fluctuations in markets without sacrificing potential returns. This is because different asset classes do not always move in sync with each other.

An undiversified portfolio often represents a bet, intentional or not, on very specific market conditions. Predicting the direction of the markets with any consistency is particularly challenging. Even though investors may feel confident that they know the direction the markets will take in the near term, unexpected events often occur. For example, major events such as wars, pandemics, and financial crises have a history of quickly changing the prevailing economic environment. This argues for designing a portfolio to weather almost all possible scenarios rather than betting on a portfolio designed to benefit from the current environment, even if an investor believes it is likely to persist.

Improving expected returns while reducing risk

By diversifying, an investor can construct a portfolio with similar risk but a higher expected target return. Alternatively, they could design a portfolio for lower risk without sacrificing expected return. This is because adding asset classes that are not correlated with the primary assets in a portfolio may decrease overall risk. This can even be true for assets that are riskier on a standalone basis, especially if they tend to be negatively correlated with the rest of the portfolio (see Figure 2).

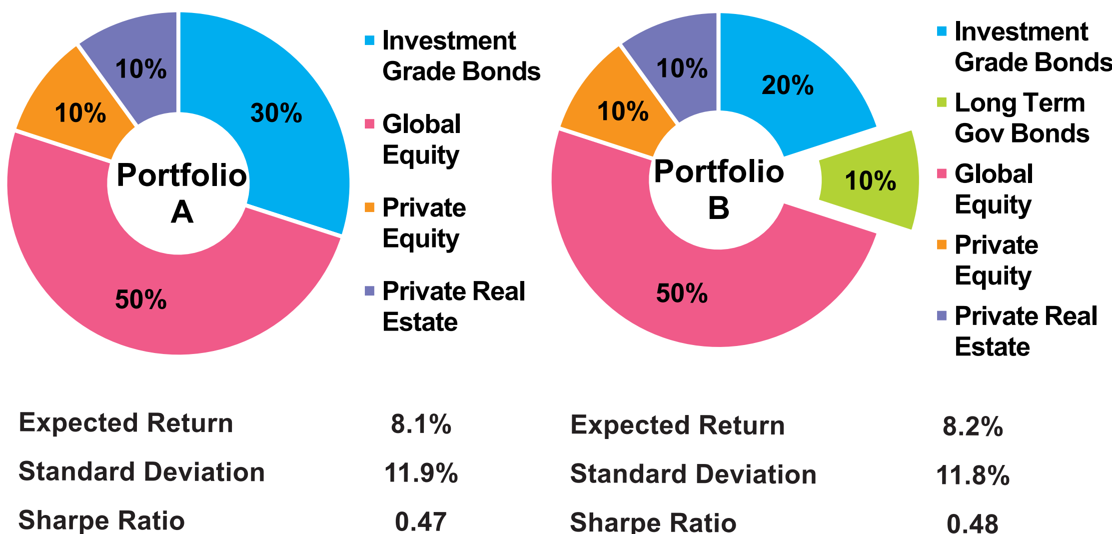

FIGURE 2
Comparison of Two Portfolios

Note: Portfolio return and risk projections shown are based on proprietary 20-year expected return and standard deviation inputs of Meketa's Asset Allocation Tool and Meketa's 2024 Capital Markets Expectations. When constructing portfolios, investors should consider the likelihood that long-run correlations may not hold under some conditions.

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Each asset class should play a specific role

It may help an investor to consider their portfolio in a similar way to how they look at their favorite sports team. For example, a successful baseball team cannot just have nine players in the shortstop position on the field. Rather, they need a team where each position plays a different and important role.

The same concept applies to portfolios – different asset classes should work together like a well-rounded team. And like players on a baseball team, some assets may have periods of “slumps” or “hot streaks.” Having a diverse team of different asset classes makes it possible for other assets to “pick up the slack” during slumps so that the overall portfolio is more protected from the volatile swings of slumps and hot streaks.

Market cycles and diversification

It is common for markets to move in cycles. And it happens at nearly every level of the financial markets – asset classes, regions, sectors, factors, rates, etc. However, the length and depth of such cycles are impossible to accurately predict. Market cycles include rotations in leadership that can last for very long periods. One asset class or style can be the best performer for an extended period, such as a decade or longer, but it can also be the worst performer for an equally long period.

Importantly, reversals/rotations in market leadership are often not widely anticipated in advance. Trying to predict or time such changes can be difficult, risky, and even dangerous. By being diversified, a portfolio is less likely to get whipsawed when a change in leadership occurs. Moreover, a diversified portfolio will lead to greater certainty in the outcome, especially over a longer horizon (see Figure 3).

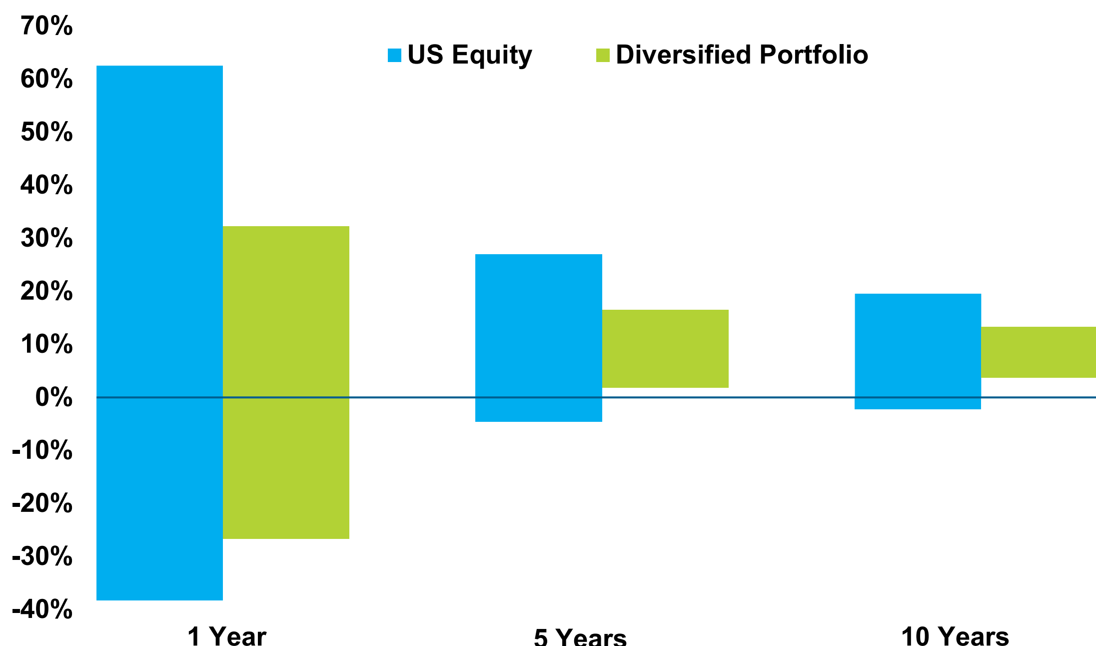

FIGURE 3

Historical Range of Annualized Returns

Data Source: Investment Metrics as of December 31, 2023. The “Diversified Portfolio” is proxied by 30% Russell 3000, 15% MSCI EAFE, 5% MSCI EM, 10% CA Private Equity, 10% NCREIF ODCE Equal-Weighted, and 30% Bloomberg Aggregate.

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How does diversification work? Smoothing out the dips

Diversification increases the likelihood of having some exposure to the best performing markets. It likewise may prevent investors from having excessive exposure to the worst markets. This may even include diversifying among asset classes that are considered risky (e.g., public and private equities). For example, between 1999 and 2010, average annualized returns were 2.8% for US stocks, 14.7% for emerging market stocks, and 13.0% for private equity.[1] Reliance on US equities alone during this period would likely have left many investors short of their objective.

A broadly diversified portfolio is likely to smooth out the worst downturns. A portfolio dominated by stocks would have suffered much worse than a diversified portfolio during the Global Financial Crisis ("GFC") or popping of the dot-com bubble (see Figure 4). Further, having investments in assets that performed well during these periods, such as high-quality bonds, not only mitigated these losses but also provided a liquid source of assets that investors could use to rebalance into assets that had become substantially cheaper (e.g., equities).

[1] Source: Data from Investment Metrics. Represents average annualized returns. Indices used are Russell 3000 index, MSCI Emerging Markets index, and CA Private Equity composite via IHS Markets.

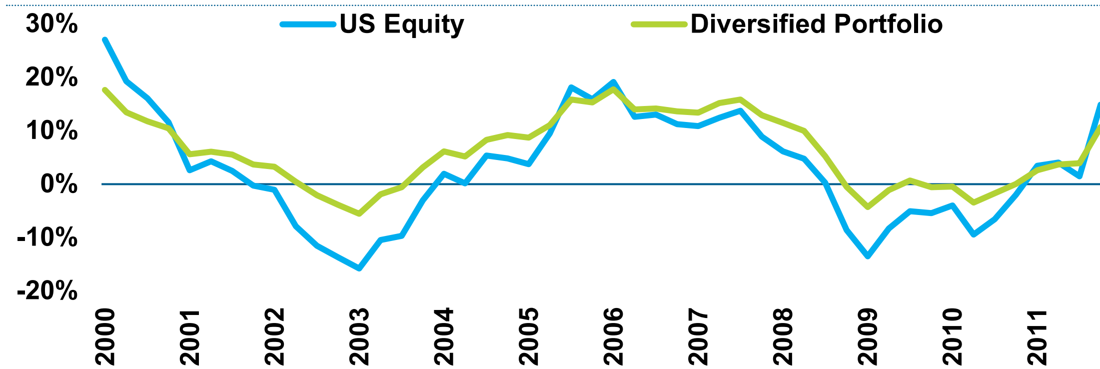

FIGURE 4
Rolling 3-Year Returns

Data Source: Investment Metrics. The period shown is from 2000 through 2011. US Equity is proxied by the Russell 3000. The diversified portfolio is proxied by 30% Russell 3000, 15% MSCI EAFE, 5% MSCI EM, 10% CA Private Equity, 10% NCREIF ODCE Equal-Weighted, and 30% Bloomberg Aggregate.

Recovering from (and mitigating) downturns

By definition, investing requires risk-taking behavior. Investors routinely take on additional risk in the hope of achieving higher returns. Taking on risk means that investors will likely, from time to time, lose money. And the more risk they take, the higher the potential loss. The rebound needed to recover from a loss grows exponentially with the size of the loss (see Figure 5). Hence most institutional investors seek to mitigate this risk by constructing a diversified portfolio.

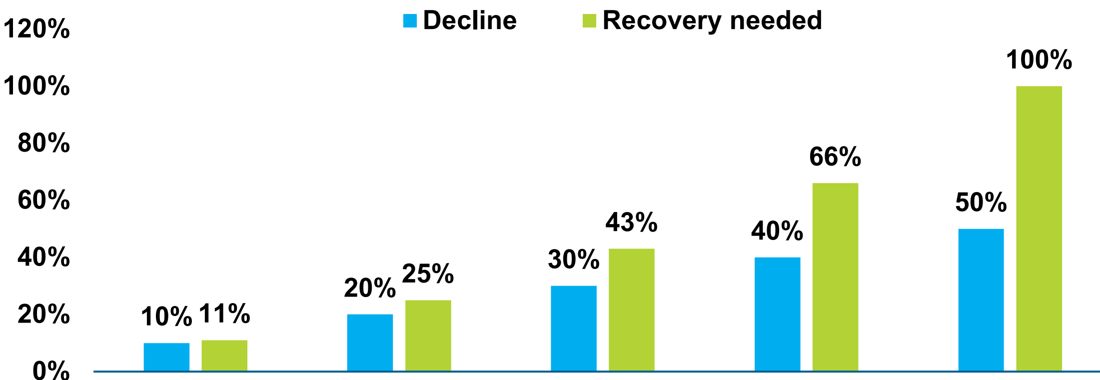

FIGURE 5
Recovery Needed to Return to Previous Value After a Loss

Source: Meketa Investment Group, 2024.

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Why should investors care about reducing volatility?

Many investors have net negative cash flows each year as their outflows (for benefits, spending, etc.) exceed their inflows. What some investors may not understand is the extent to which negative cash flows make it harder for them to recover after a market downturn.

For example, in Figure 6 we show three scenarios, all of which have the same level of negative cash flows and produce the same average annualized return over a twenty-year horizon. Yet the three scenarios have very different ending points. This is because two of the scenarios experience below average returns for years 1-10, which when combined with the negative cash flows, provides a lower base on which to compound those assets even when they achieve higher returns in years 11-20. The scenario that has the lowest endpoint is the most volatile of the three scenarios.

The larger the cash outflows and volatility are, the more severe the impact. In other words, an investor could earn their target rate of return over 20 years, but still find themselves short of their target market value (or funded status). Diversified portfolios reduce the level of volatility that would otherwise amplify this shortfall and thus provide greater certainty around the eventual outcome.

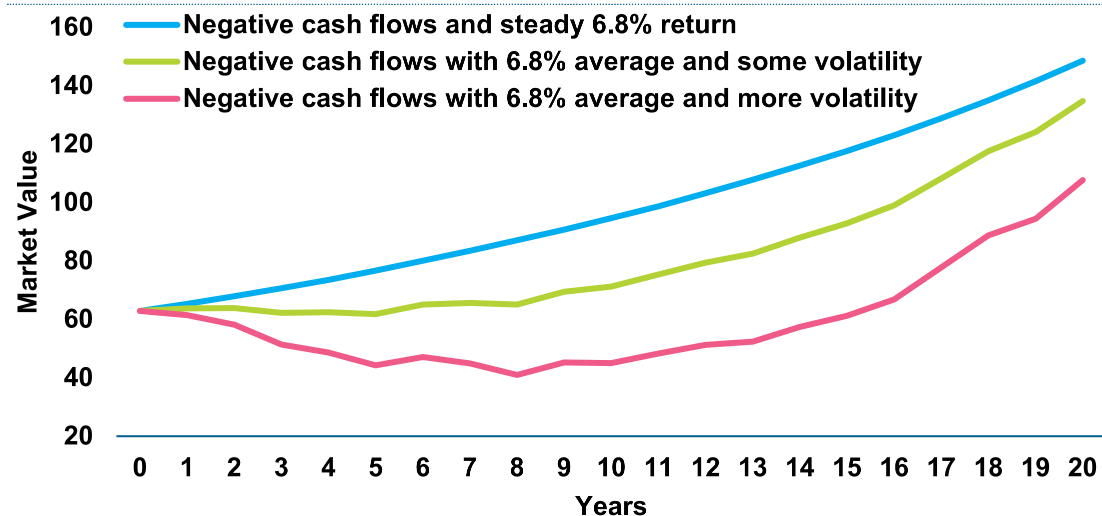

FIGURE 6
Example Impact of Volatility and Cash Flows on Returns

Source: Meketa Investment Group, 2024. All three paths will generate the same average annualized return over 20 years. For the "some volatility" path, the first 10 years will earn an annualized return approximately equal to the 25th percentile return for the selected asset mix over 10 years, and the second 10 years will earn an annualized return equal to the 75th percentile. For the "more volatility" path, the average returns are at the 5th and 95th percentile, respectively.

Endpoint bias

Historical returns may present a biased or incomplete picture, depending on the time period chosen, particularly when they represent a single "snapshot" of time. Such "endpoint bias" refers to the inclusion or exclusion of data that significantly skews results. That is, if the recent past (or the starting period) witnessed unusually high or low returns, then long-term results can change considerably. Often, this results from typical market cyclicality. Sometimes, the data is so extreme that it creates true anomalies.

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Relying solely on data that is biased in this fashion can result in investors making flawed decisions. The last decade is replete with trends that are affecting long-term data, and hence they may skew the way investors' decisions are framed. It can be too easy for investors to give up on certain asset classes and load up on the asset class that has been in favor recently. Doing so has been costly historically when regimes change.

Being cognizant of endpoint bias can help investors make more informed (and hopefully better) decisions. Looking at rolling-period analysis may help, since it treats the endpoint as a single data point. Below, we examine two historical examples of endpoint bias.

Endpoint bias example: market cycles

Value and growth stocks tend to move in cycles of relative outperformance. As of March 2000, the Russell 1000 Growth index outperformed its Value counterpart over all trailing periods, fueled by impressive recent performance (see Figure 7).

As of 03/31/2000	1 YR (%)	5 YR (%)	10 YR (%)	20 YR (%)	Since Inception (%)
Russell 1000 Growth	34.1	31.8	21.6	18.5	18.3
Russell 1000 Value	6.3	21.0	16.0	17.2	16.8

FIGURE 7
Annualized Returns as of March 2000

Source: Data is from Bloomberg. Inception for both Russell 1000 Growth and Russell 1000 Value indices was January 1979.

From this data, investors might have concluded that growth stocks offer a long-term premium relative to value stocks. However, just one year later with the bursting of the dot-com bubble, the premium had reversed over all historical periods (see Figure 8).

As of 03/31/2001	1 YR (%)	5 YR (%)	10 YR (%)	20 YR (%)	Since Inception (%)
Russell 1000 Growth	-42.7	11.6	12.7	13.2	14.5
Russell 1000 Value	0.3	14.2	15.2	15.3	16.0

FIGURE 8
Annualized Returns as of March 2001

Source: Ibid.

Endpoint bias example: anomalies

For the twenty-year period ending February 2008 (before the GFC had decimated equity markets), the US stock market had earned 3.4% more on average per annum than the core bond index (see Figure 9). This was only slightly below the long-term premium observed for stocks over bonds. However, when measured one year

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later (around the time the stock market hit its nadir), investment grade bonds had outperformed stocks by an annualized 0.2% over the twenty-year period. Note that this relationship (of bonds outperforming stocks) only lasted for one month.

	20 Years As of 2/2008 (%)	20 Years As of 2/2009 (%)	20 Years As of 2/2024 (%)
Russell 3000	10.8	7.1	9.8
Bloomberg Aggregate	7.4	7.3	3.0

FIGURE 9
Annualized Returns

Source: Data is from Investment Metrics.

Human behavior and performance chasing

Many investors suffer from behavioral biases that may result in performance-chasing behavior. They are often fearful when the market declines and hence get more conservative at an inopportune time. Conversely, they may also chase good returns by investing in risky assets after a period of strong investment gains. Succumbing to these mistakes may lead to poor decisions, and hence poor portfolio outcomes. This is partly because return-chasing behavior often leads to buying high and selling low.

Evidence shows that investors' performance lags the actual performance of the funds/markets in which they invest (see Figure 10). Specifically, the time-weighted average return for a fund tends to be higher than the dollar-weighted return. This implies that investors have piled money into funds after those funds have achieved their best performance and that investors have tended to leave their money in those funds after performance fell below average.

US Category Group	Investor Return (%)	Total Return (%)	Performance Gap
US Equity	10.99	11.77	-0.79
International Equity	3.30	4.89	-1.59
Sector Equity	6.42	10.80	-4.38
Taxable Bond	0.20	1.57	-1.36
Allocation	5.98	6.44	-0.46
Overall	**6.04**	**7.71**	**-1.68**

FIGURE 10
The Performance Gap by Asset Class (10-Year Returns)

Source: Morningstar, "Mind the Gap 2022." https://www.morningstar.com/funds/bad-timing-cost-investors-one-fifth-their-funds-returns. Morningstar updates the study annually, with roughly similar results each year, showing that the returns that investors experience is below the returns that the funds produce because of the manner in which investors tend to move in and out of funds in each category.

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Why be patient?

In general, investors should typically be patient with underperforming asset classes because market cycles can cause fluctuations in performance, and asset classes that are currently underperforming often rebound over time. Patience usually allows investors to ride out the volatility and potentially benefit from the long-term growth that these asset classes may offer.

Additionally, having a long-term perspective is typically beneficial. Investors may profit by suppressing the urge to always "do something." Often the best course of action is to take no short-term action at all, especially if they are inclined to chase performance or over-react to recent events. If an investor truly has a long-term horizon, they are generally best served by acting as a long-term investor.

Having discussions about and setting appropriate expectations around market cycles is an important aspect of effectively managing the situation if underperformance happens. This might include scenario analysis and stress testing, as well as looking at performance with an eye toward endpoint bias. This preparation for, and understanding of, risk can contribute to the patience needed to stay the course with underperforming asset classes.

Part II: Current markets

As is common in financial markets, recent years have been full of winners and losers (see Figure 11). Some markets have outperformed while others have underperformed. However, in many cases, the differences are so extreme that they are impacting even very long-term returns.

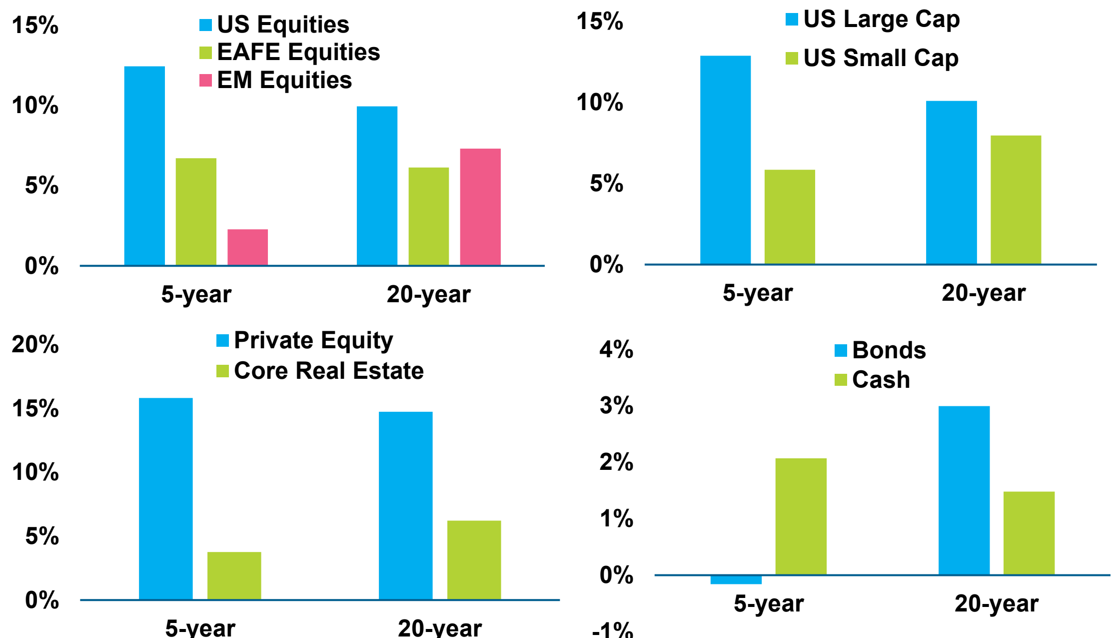

FIGURE 11
Average Annualized Returns

Represents the period ending April 2024 for public markets and December 2023 for private markets. Data is from Investment Metrics. Benchmarks used are: Russell 3000 for US Equities, MSCI EAFE for EAFE Equities, MSCI EM for EM Equities, Russell 1000 for US Large Cap, Russell 2000 for US Small Cap, CA Private Equity for Private Equity, NCREIF ODCE Equal-Weighted for Core Real Estate, Bloomberg US Aggregate for Bonds, and Bloomberg 1-3 Month US T-Bills for cash.

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In the sections that follow, we briefly discuss several markets where investors should be thinking about recent performance (with an eye on endpoint bias and performance chasing) when examining the long-term returns for those asset classes.

Cyclicality in regional equity markets

Over the last forty years, we have seen ~five super cycles in global equity markets (see Figure 12). EAFE equities, elevated by Japanese stocks, led the way for much of the 1980s. Emerging market equities mainly dominated the next twenty years. This was punctuated by significant outperformance in 1988-93 and again in the 2000s. Since 2011, US equities have outperformed by a wide margin. As we noted at the outset of this piece, it is the outperformance of US equities – and large cap/growth/tech stocks in particular – that have captured the attention of many investors.

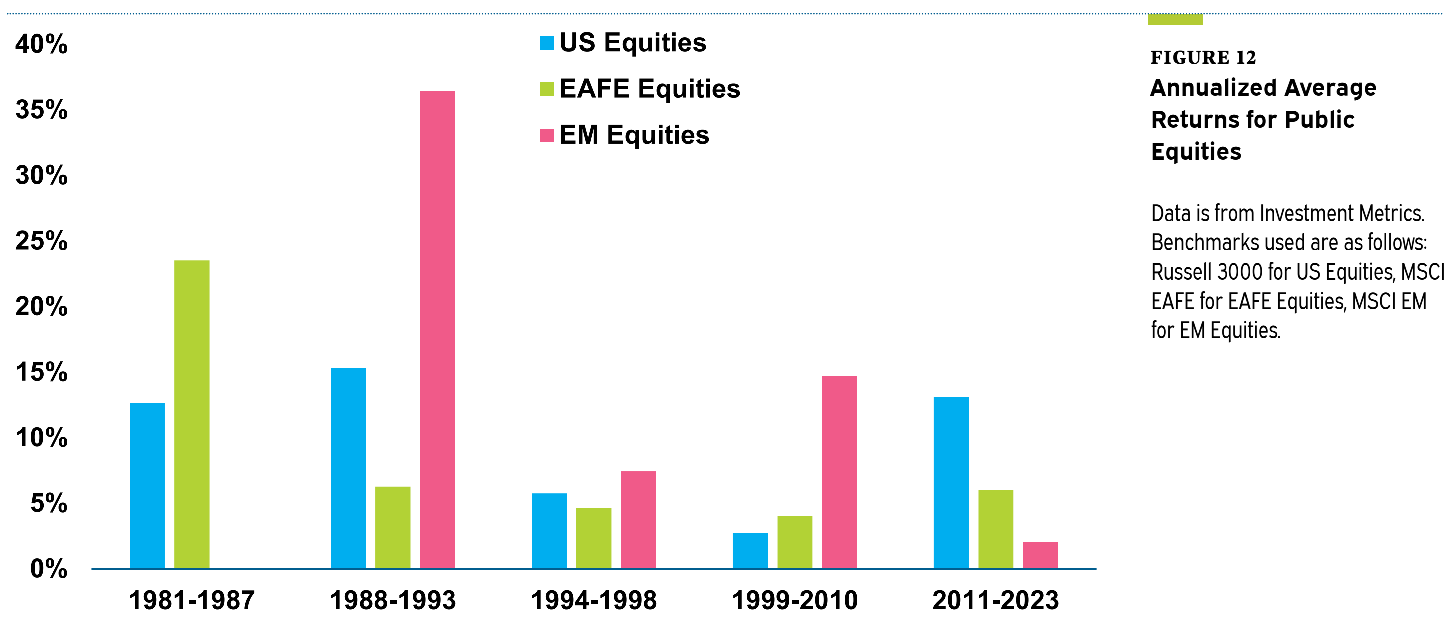

FIGURE 12
Annualized Average Returns for Public Equities

Data is from Investment Metrics. Benchmarks used are as follows: Russell 3000 for US Equities, MSCI EAFE for EAFE Equities, MSCI EM for EM Equities.

Relative valuations in equity markets

Currently, the US stock market is trading at a much higher valuation than the other major global stock indices (see Figure 13). However, it is not unusual for the US market to trade at higher valuations than other markets, as exhibited by the trailing 25-year average. Still, the US market is also trading well above its own long-term average, though it is trading below its two previous peaks during the dot-com bubble and the post-COVID recovery.

EAFE equities are trading near their historical average. Emerging market equities are trading below their historical average, not least because of the pessimism surrounding Chinese equities in recent years. Taken together, this data implies relative optimism on the part of investors for US stock markets relative to overseas stocks.

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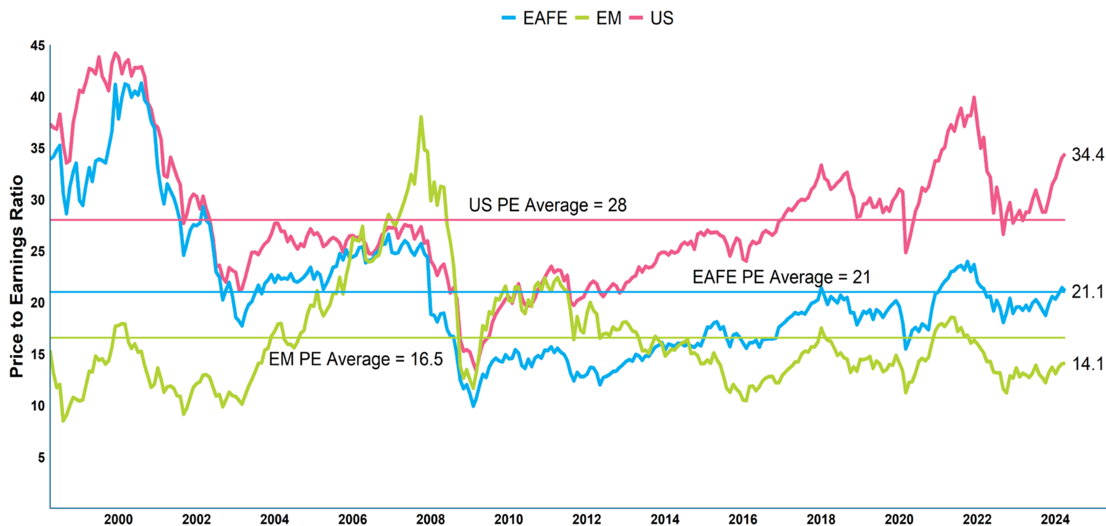

FIGURE 13

Price-Earnings Ratio for Public Equity Markets

US Equity Cyclically Adjusted P/E on S&P 500 Index. Source: Robert Shiller, Yale University, and Meketa Investment Group. Developed and Emerging Market Equity (MSCI EAFE and EM Index) Cyclically Adjusted P/E – Source: Bloomberg. Earnings figures represent the average of monthly "as reported" earnings over the previous ten years. Data is as of April 2024. The average line is the long-term average of the US, EM, and EAFE PE values from April 1998 to the recent month end respectively.

Is optimism warranted?

Perhaps a key factor in the differing outlooks for US and overseas markets is the vast difference in earnings growth experienced by the market since earnings per share ("EPS") peaked for the EAFE and EM indices around 2011 (see Figure 14). Since then, EPS growth for EAFE stocks has been relatively flat, averaging less than 2% per year. EPS growth for emerging markets has been negative over the period. Meanwhile, US EPS growth has been strong over the past two decades, more than doubling since 2011. The difference in returns since 2011 coincides with the difference in earnings growth. And it is possible – even likely – that investors are extrapolating these trends into the future when they value these respective markets today.

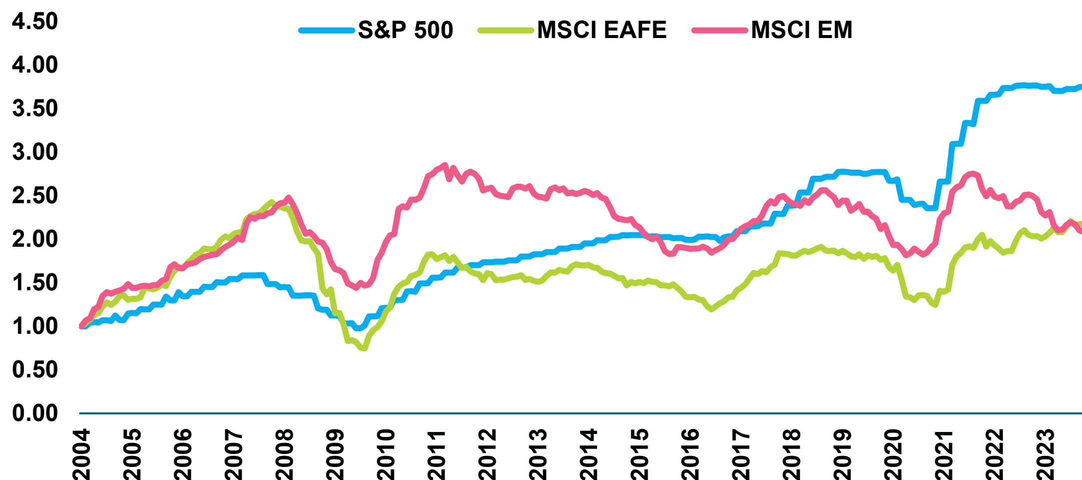

FIGURE 14

20-Year EPS Growth, indexed to $1

Source: Meketa analysis of MSCI and Bloomberg data. Series uses Trailing 12-month earnings per share in USD. As of May 31, 2024.

Leading the way: Technology and artificial intelligence

Post-COVID, the fuel for US earnings growth has been primarily the technology and related sectors. Most recently it is being driven by companies linked to artificial intelligence ("AI"). The US market has higher allocations to the technology sector than most overseas markets (see Figure 15), along with many leading AI companies.

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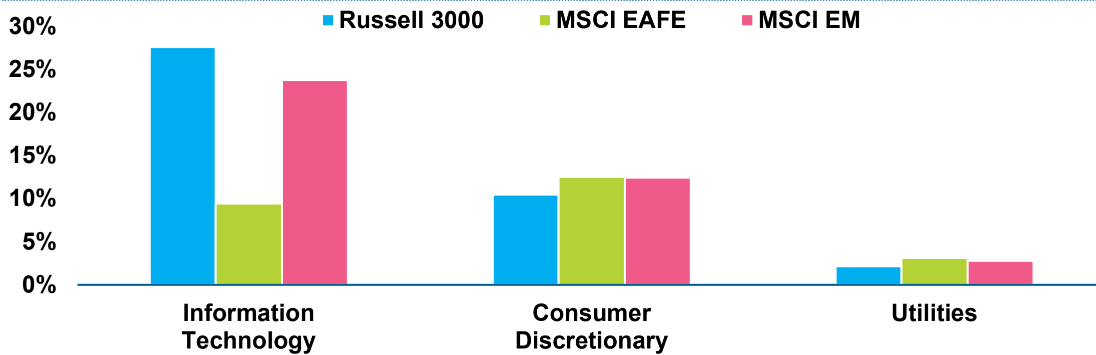

FIGURE 15

Sector Allocations

Source: Data is from FactSet, as of March 31, 2024. Note that Amazon is in the Consumer Discretionary sector. Utilities and data centers have recently outperformed due to a "picks and shovels" thesis (i.e., AI needs will cause a high demand for electricity and data centers for training LLMs).

US market concentration[2]

Moreover, US market returns since the pandemic have been driven by a handful of US companies. The dot-com bubble was the last time the top ten's influence on returns was this high for a sustained period (see Figure 16).

[2] See Meketa's paper titled "The Magnificent Seven" for a fuller discussion of the concentration risk in the US market.

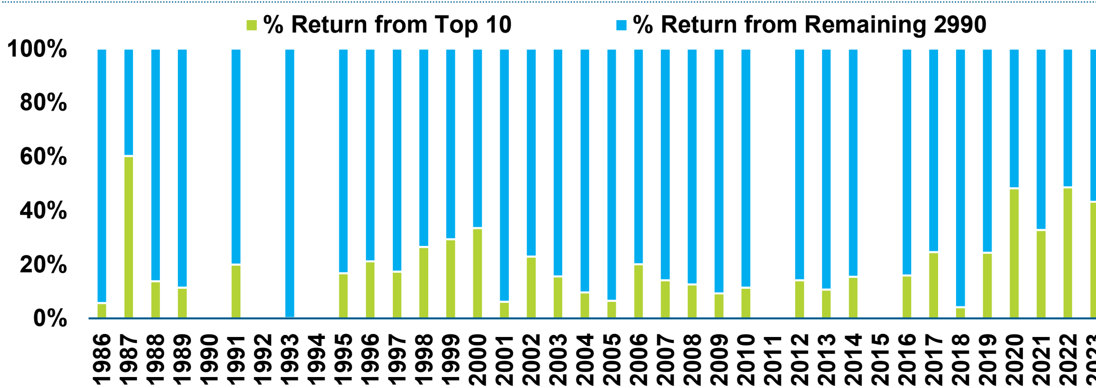

FIGURE 16

% Contribution to Annual Return of the Russell 3000

Source: FactSet, as of December 31, 2023. Note that Alphabet Class A and C were combined into one category for this analysis. In years 1990, 1992, 1994, 2011, and 2015, the top 10 and the rest moved in opposite directions, making the stacked column not meaningful; hence they were excluded from the chart.

Impact within the US equity market: growth vs value

Large growth stocks have outperformed value stocks by a wide margin since the GFC. The recent outperformance of large tech-related stocks (which tend to pervade the growth indices while being absent from the value indices) has widened this gap. The amount of outperformance by growth stocks in recent years has been more than sufficient to erase the long-term outperformance (since 1979) that value stocks had previously held over growth stocks in the US.[3] As discussed earlier, growth and value tend to move in cycles of relative performance. Note that the last period of significant growth outperformance was the dot-com bubble, which did not end well for growth stock investors (see the 2000-2008 returns in Figure 17).

[3] From 1979 through 2023, the average annualized return for the Russell 1000 Value is 11.6%, and for the Russell 1000 Growth is 12.0%.

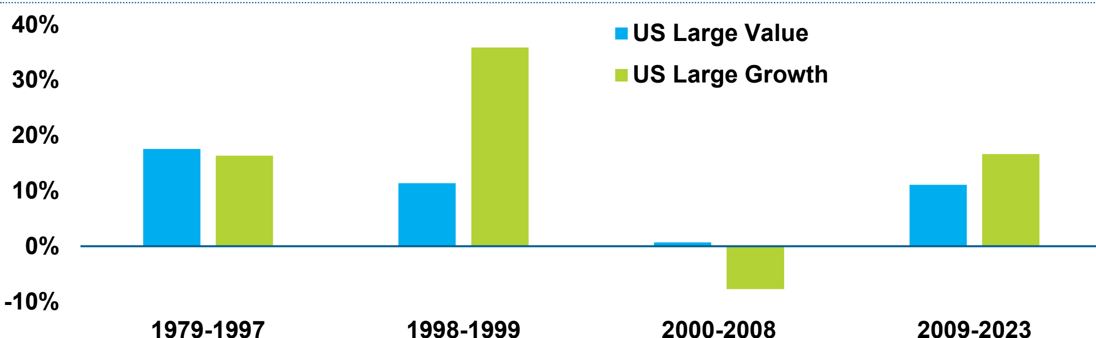

FIGURE 17

Annualized Average Returns for US Growth and Value

Benchmarks used are as follows: Russell 1000 Value for US Value and Russell 1000 Growth for US Growth.

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Value stocks appear cheap and growth stocks appear expensive by historical standards (see Figure 18). While relative pricing is not nearly as extreme as it was during the dot-com bubble, it is far from its historical average.

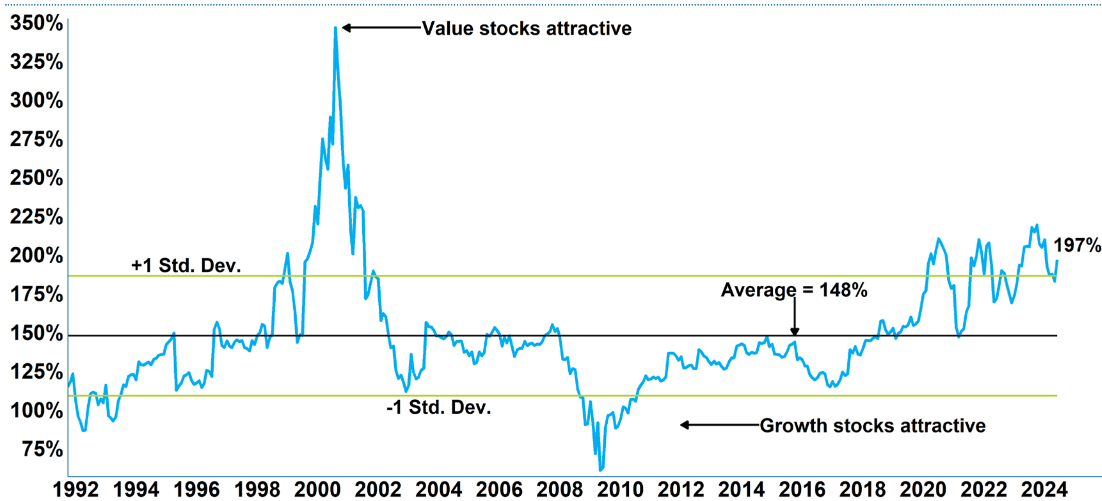

FIGURE 18
Growth P/E vs. Value P/E

Growth P/E (Russell 3000 Growth Index) vs. Value (Russell 3000 Value Index) P/E. Source: Russell Investments, Bloomberg, and Meketa Investment Group. Earnings figures represent 12-month "as reported" earnings.

Impact within the US equity market: small vs large

Along a similar vein, large cap has outperformed small cap since the GFC, with the gap widening over the past five years. This has likewise erased the long-term outperformance (since 1979) that small cap held over large cap stocks.[4] Such relative outperformance has reversed historically, though sometimes it was not for a very long period. The last major reversal was related to the peak and subsequent popping of the dot-com bubble (see Figure 19).

[4] From 1979 through 2023, the average annualized return for the Russell 1000 is 12.0%, and for the Russell 2000 is 11.0%.

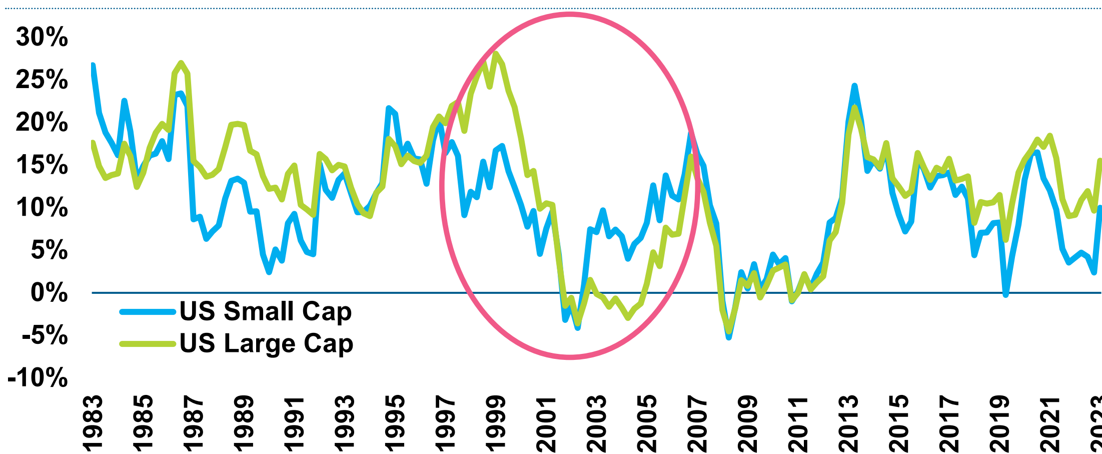

FIGURE 19
Rolling Five-Year Annualized Returns

Benchmarks used are as follows: Russell 1000 for US Large and Russell 2000 for US Small.

Perhaps unsurprisingly given the trends discussed thus far, small cap stocks appear inexpensive and large stocks look pricy based on history (see Figure 20). Again, relative pricing has not hit its extreme, but it is far from the historical averages. This implies willingness by investors to pay a higher-than-normal premium for the higher presumed growth of large cap (and growth) stocks.

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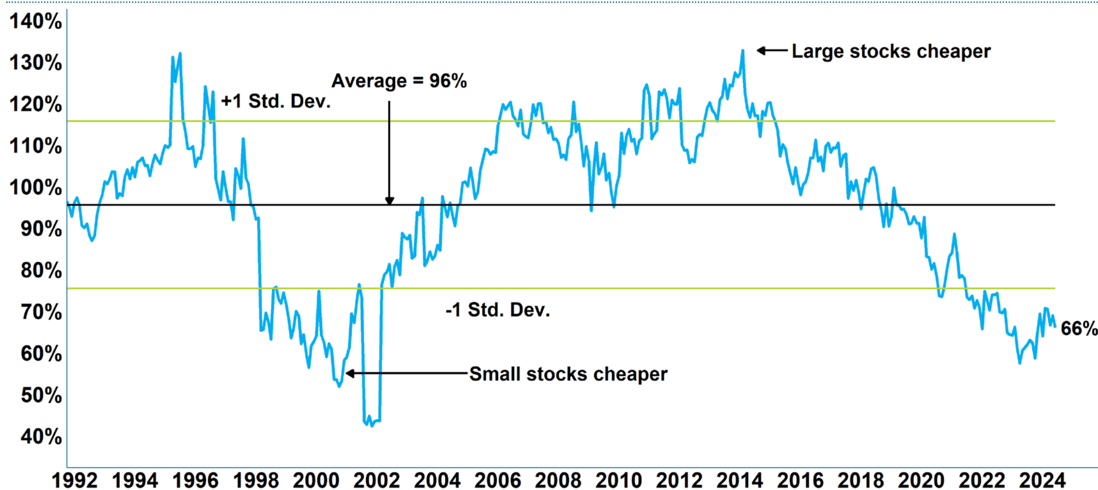

FIGURE 20
Small Cap P/E vs. Large Cap P/E

Small Cap P/E (Russell 2000 Index) vs. Large Cap P/E (Russell 1000 Index) - Source: Russell Investments, Bloomberg, and Meketa Investment Group. Earnings figures represent 12-month "as reported" earnings.

The case for ongoing US equity outperformance

Investors who are relying on the continued outperformance of US equities are making a number of bets, consciously or not, that may include the following:

→ The Fed will lower interest rates later this year, and short-term rates will continue to decline (albeit gradually) thereafter.

→ Inflation will continue to decline and settle in near the Fed's long-term target at some point in the next year or two.

→ Unemployment will remain low.

→ The US economy will grow faster than its developed market peers.

→ The profitability of a select number of large cap growth companies (particularly in the tech sector) will outpace the broader market.

→ This will be fueled by productivity growth and spending that is primarily attributable to AI.

→ US companies will maintain their dominant position in the AI ecosystem.

While the probability of some of these outcomes playing out is high, the likelihood of all of them occurring strains traditional economic theory. And this ignores the potential for an unexpected geopolitical or market event.

Bonds

The stock market is not the only place where recent performance has led to unusual backward-looking performance numbers. Returns for investment grade (e.g., "core") bonds have been poor – even negative – due to the rise in interest rates since 2020 (see Figure 21). Yet this is good news for investors on a forward-looking basis. This is because the best predictor of future returns for investment grade bonds is their current yield (see Figure 22). Rising rates have elevated yields to levels last seen prior to the GFC. Higher yields may give investors more options than they have had in constructing their portfolios in more than 15 years.

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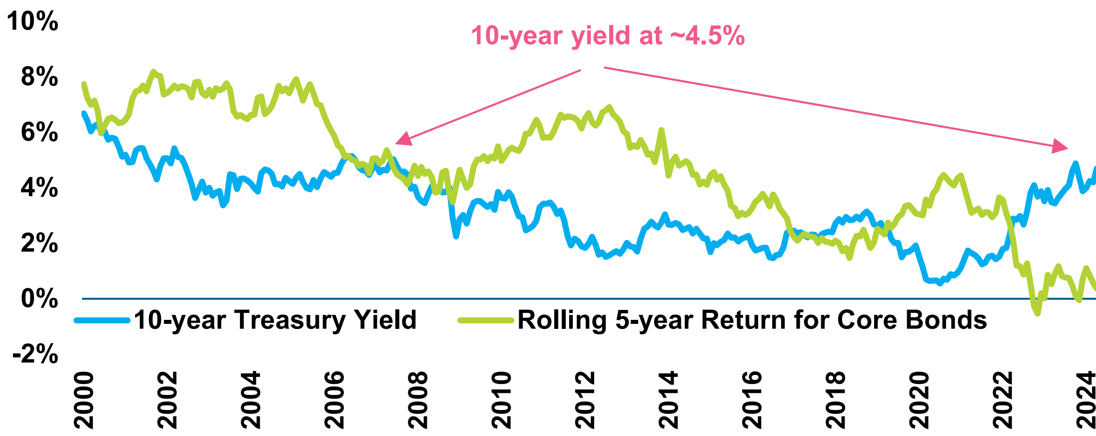

FIGURE 21
Treasury Yields and Core Bond Returns

Data source is FRED for the 10-year Treasury yield and Investment Metrics for Core Bond performance. The Bloomberg Aggregate index was used for Core Bonds. Data is as of April 2024.

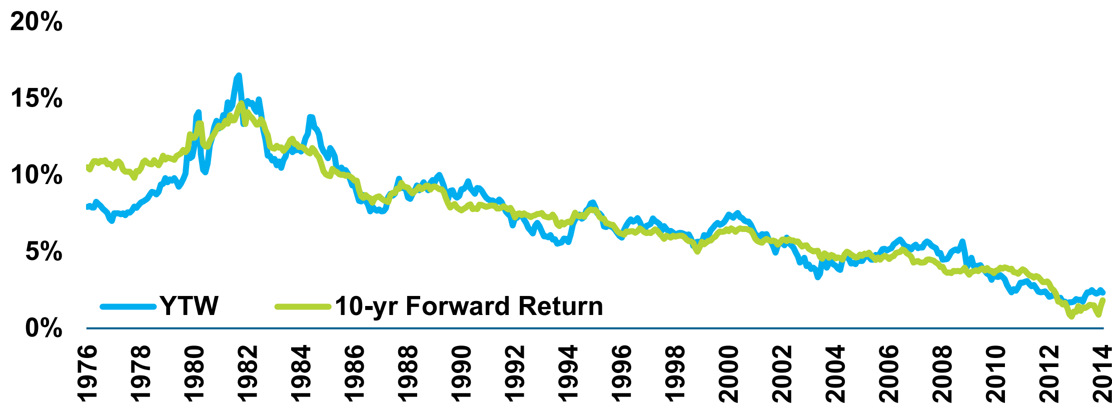

FIGURE 22
YTW and Forward Returns for Core Bonds

Data source is Bloomberg for yield-to-worst and Investment Metrics for Core Bond's 10 year forward return. The Bloomberg Aggregate index was used for Core Bond's 10 year forward return. Data is as of December 2023.

Summary

Diversification is an important component of investing. A well-diversified portfolio may improve expected risk-return tradeoffs and is less reliant on specific market conditions. Market cycles can cause dramatic fluctuations in performance. The duration of such cycles can be painfully long. Yet such extended periods of out- and underperformance are normal in most markets.

Investors should be mindful of endpoint bias and behavioral biases. Investors tend to place undue significance on recent events and extrapolate the recent past into the future. By being aware of such biases, investors may minimize the likelihood of making potentially flawed investment decisions. This includes selling underperforming assets at the wrong time.

Distinguishing between secular changes and cyclical trends is challenging at best. Investors who develop a long-term plan and stick with it may be able to avoid the worst outcomes. The combination of patience and diversification will likely help investors avoid being adversely affected by shifts in market leadership.

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