



# The Joseph Wealth Counsel Journal

August 2005

**ABOUT THIS PUBLICATION.** Reviewing the historical returns of various asset classes, as well as projecting future returns of asset classes, can lead to a better understanding of the strategies underlying the design of your investment portfolio. In this publication we present various historical data on the returns of various asset classes, the returns of select mutual funds and indices, and our updated projections for the long-term estimated future returns of asset classes.

This publication is designed for the use of our clients and prospective clients and is updated quarterly. The data herein is presented for educational and reference purposes only.

Joseph Capital Management, LLC employs research from Nobel-Prize winning financial economists and other academics, as well as its own proprietary research as to asset class valuation levels relative to historic levels, to design and construct investment portfolios for our clients. Utilizing low-cost investment products and tax-efficient investment portfolio design, we seek to reduce the various risks to which our clients may otherwise be exposed while achieving each client's desired long-term after-tax rate of return.

If you have any questions or suggestions regarding the content of this publication, or other questions regarding the design of your investment portfolio, please feel free to give me a call, or e-mail me at [rrhoades@josephpartners.com](mailto:rrhoades@josephpartners.com).

*Thank you!* Ron A. Rhoades, B.S., J.D., CFP®, Director of Research  
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## Newsletter Publications of the Joseph Financial Group

*Joseph Financial Group's Wealth Counsel & Perspectives:* Articles from our directors and team members in each issue address aspects of tax, financial, and estate planning. Published four times a year. Publication dates vary depending upon tax and other developments.

*Joseph Capital Management's Quarterly Capital Markets Commentary:* A 4-page publication providing succinct analysis for our investment advisory clients. Published in January, April, July and October.

*The Joseph Wealth Counsel Journal:* This publication provides a detailed article in each issue on an aspect of investment theory or investment portfolio design, as well as charts on historical and expected future asset class returns. It is designed for our investment advisory clients who desire greater insights into Modern Portfolio Theory. Published in February, May, August, and November.

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For more information about our firm and our services, please visit our web site, [www.JosephPartners.com](http://www.JosephPartners.com), or call us for a no-obligation initial conference to ascertain if our professional services can benefit you.



## Feature Article: Examining Recent Stock Market Downturns With Hypothetical Portfolios

In a period of generally overvalued markets, as we are today, it may be interesting to pause and reflect upon the “best” and “worst” case returns of the past 35 years for various portfolios. To do this, we constructed five different portfolios for comparison purposes using the Fama/French simulated indices and the MSCI EAFE (Europe, Australia, Far East) index to represent various stock asset classes.

We chose an index of 5-year U.S. Treasury Notes returns to represent the fixed income component of the hypothetical portfolios. Each portfolio has a substantial value and small cap tilt. For purposes of comparison, we include one portfolio which is simply 80% U.S. large company stocks and 20% fixed income. The construction of these portfolios is shown in the table, below.

Asset Class (Index)	80% US Large Cap 20% Fixed Income	80% stocks, 20% fixed income	60% stocks, 40% fixed income	40% stocks, 60% fixed income	20% stocks, 80% fixed income
Fama/French US Large Cap Index	80%	30%	22.5%	15%	7.5%
Fama/French US Large Cap Value Index	0%	15%	11.25%	7.5%	3.75%
Fama/French US Small Cap Index	0%	15%	11.25%	7.5%	3.75%
Fama/French US Small Cap Value Index	0%	8%	6%	4%	2%
MSCI EAFE Index (Net)	0%	12%	9%	6%	3%
5-Year US Treasury Notes	20%	20%	40%	60%	80%

Sources of Data: DFA Returns Software, utilizing information supplied by Professors Eugene Fama, Sr. and Kenneth French, MSCI, and Ibbotson Associates. Data is Copyright © 2005 by the aforementioned sources. Utilized pursuant to license from Dimensional Funds Advisors. For additional information regarding these indices and their construction, please refer to the appendices. These are *not* JCM Model Portfolios.

As we might expect, as we examine the returns of these portfolios over the past four decades, generally the higher annualized returns occur from the portfolios which are weighted more heavily toward stocks. Additionally, the 80% stocks / 20% fixed income portfolio which is “small

cap” and “value” tilted generally outperforms the portfolio consisting of only 80% U.S. large company stocks and 20% fixed income. This again illustrates the “small cap” and “value” effect, which is generally seen in various stock markets around the world over long time periods.

Average Annualized Returns of Hypothetical Portfolios	80% US Large Cap 20% Fixed Income	80% stocks, 20% fixed income	60% stocks, 40% fixed income	40% stocks, 60% fixed income	20% stocks, 80% fixed income
January 1970 – December 1979	6.23%	9.10%	8.73%	8.26%	7.68%
January 1980 – December 1989	16.32%	17.71%	16.40%	15.00%	13.49%
January 1990 – December 1999	16.14%	13.58%	12.05%	10.45%	8.82%
January 2000 – May 2005	-0.19%	4.12%	5.16%	6.05%	6.78%
ENTIRE PERIOD: 1/1970 to 5/2005	10.71%	11.94%	11.22%	10.40%	9.47%

Past performance is not a guarantee of future returns. For important disclosures, please see the appendices.

**-cont. Examining Recent Stock Market Downturns with Hypothetical Portfolios**

But how did each of these portfolios perform during significant stock market downturns? Using monthly data from 1970 through May 2005 we examine various periods during which any one of these portfolios declined significantly (generally,

10% or greater decline in value; we add Jan-April 2005 for informational purposes). The resulting ten periods in which significant downturns occurred (measured by total return) are set forth below:

TOTAL RETURNS for Periods of Substantial Negative Returns for the hypothetical portfolios, 1970-2005	80% US Large Cap 20% Fixed Income	80% stocks, 20% fixed income	60% stocks, 40% fixed income	40% stocks, 60% fixed income	20% stocks, 80% fixed income
April 1970 through June 1970	-15.56%	-16.48%	-12.63%	-8.67%	-4.59%
January 1973 through Sept. 1974	-37.01%	-33.43%	-25.09%	-15.95%	-5.98%
Sept. 1979 through October 1979	-6.18%	-7.29%	-6.62%	-5.95%	-5.29%
February 1980 through March 1980	-9.39%	-11.74%	-9.97%	-8.27%	-6.64%
December 1981 through July 1982	-9.24%	-6.84%	-3.08%	+0.80%	+4.79%
September 1987 through Nov. 1987	-23.18%	-21.80%	-15.95%	-9.97%	-3.86%
June 1990 through October 1990	-11.68%	-14.22%	-9.66%	-4.92%	-0.02%
July 1998 through August 1998	-12.58%	-13.62%	-9.55%	-5.42%	-1.24%
April 2000 through September 2002	-30.47%	-22.54%	-10.15%	+3.60%	+18.79%
January 2005 through April 2005	-3.00%	-4.03%	-2.91%	-1.80%	-0.69%

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**What can we conclude from these observations?**

- Stock market downturns occur frequently. At times these downturns can be both prolonged and substantial.
- While tilting a portfolio toward small cap and value stocks enhances returns, this does *not* always temper the effect of stock market downturns. The 2000-2 downturn was an exception—as growth stocks declined and value stocks generally trended upward.
- The best way to temper the effect of a downturn in the stock market upon your investment portfolio, and its effect upon your financial well-being, is to reduce your overall allocation to stocks and increase your allocation to fixed income. However, this will also likely negatively affect your long-term (15 or more years) portfolio returns.
- Increasing the allocation to small cap and value stocks, while decreasing the allocation to stocks, often provides a “smoother ride” with similar long-term returns. (However, there are points in time when value and small caps are overvalued relative to large cap stocks, and subsequent long-term portfolio returns may not reflect these effects.)
- Stock market investing is, and always will be, a very long-term endeavor. A disciplined approach, employing a sound strategic asset allocation strategy, rebalancing, and the guidance of Joseph Capital Management, LLC, should enable you to best capture the returns the capital markets have to offer.