CIO reiterates their view that investors should look for the right balance of US large-caps, international and small-cap stocks, and quality bonds in their portfolios to position for long-term returns. (UBS)

History shows equity dominance and benefits of diversification

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Markets shrugged off another strong US inflation print on Tuesday, with the S&P 500 rising 1.1% to close at its 17th all-time high this year. Led by large-cap tech stocks, the benchmark index has risen 8.5% year-to-date and has gained 25.7% since late October.

All-time highs often generate investor concern that markets have peaked, but such worries are not supported by history. Over the past 60 years, the S&P has traded within 5% of a record high 60% of the time, and more than 20% below its last all-time high only 12% of the time. If we go back even further, equity returns have dominated cash, according to findings in the latest Global Investment Returns Yearbook published at the end of February. The study, which provides historical perspective on the financial markets since 1900, has been conducted for 25 years by professors Elroy Dimson of Cambridge University, and Paul Marsh and Mike Staunton of the London Business School.

We continue to believe that investors should stay invested, and that a diversified, balanced portfolio remains the best way to preserve and grow wealth. Several key findings in the Yearbook, based on 124 years of history, support this view:

Equities dominate in long-term investment returns. Since 1900, equities have outperformed bonds, bills, and inflation in all 21 countries for which the Yearbook has a continuous history. In the US, an initial investment of USD 1 grew to USD 87,620 in nominal terms by the end of 2023. In real terms, such an initial investment, with dividends reinvested, would have grown in purchasing power by 2,443 times. This means that US equities have returned 6.5% per year in real terms over the last 124 years. There were significant drawdowns, of course, and there have been four bear markets so far during the 21st century. Each shock was severe at the time. At the depths of the Wall Street Crash that started in 1929, for example, US equities had fallen by 80% in real terms. However, equities eventually recovered and gained new highs—and significant drawdowns now just appear as setbacks within a longer-term secular rise.

The case for diversification is compelling in equities… Investment in equities has proved rewarding over the long run, but it has also been accompanied by correspondingly greater risks. After the Wall Street Crash, US equities took 15.5 years to recover. This, of course, is an extreme example, but it also points to the foundation of modern portfolio theory—diversification. In line with our view, the Yearbook authors advise investors from all countries, including the US, to invest globally to reduce risk. Based on 124 years of history, investing in a capitalization-weighted, 21-country portfolio would see risk reduced by 40% when compared to a single-country investment.

…and across asset classes. The same diversification principle applies across asset classes. Since 1900, the standard deviation of real US equity returns has been 19.9%, while that of a 60/40 equity/bond portfolio was 13.5%. Government bonds have delivered a positive real return over the long term, but investing in high-quality corporate bonds can enhance returns as well as provide diversification benefits. Evidence from 1900 for the US and 1860 for the UK show that investment grade corporate bonds have offered a significant credit risk premium over equivalent government bonds of around 1 percentage point. We recommend investors consider exposure to actively managed fixed income strategies to take full advantage of the breadth of opportunity in the fixed income asset class.

So, we reiterate our view that investors should look for the right balance of US large-caps, international and small-cap stocks, and quality bonds in their portfolios to position for long-term returns. We also think that investors willing and able to manage risks inherent to alternative assets, like lower liquidity, should consider hedge funds and private markets for potentially higher returns and broader exposure.

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