Past Performance Is No Guarantee

We at Rockwood often counsel that "past performance is not an indicator of future outcomes" when it comes to mutual funds. Investors are often drawn to funds with favorable track records and judge funds by performance metrics. They believe this is a sound strategy that will result in a favorable financial outcome. However, data shows that in reality, exactly the opposite is true.

S&P's Aye Soe reviewed the performance of 641 actively managed stock mutual funds, to understand whether top-performing funds maintained their status over time. Among the funds with top-quartile returns through March 2014, only 7.3 percent of them remained in the top quartile in March 2016. **In other words, 92.7 percent of top-performing funds from 2014 failed to deliver top returns just two years later.**

Expanding the view to the top half of funds by performance, only 27.4 percent stayed in the top half after two years. Soe further tracked performance over a four-year period, and she found that of funds in the top quartile in March 2012, only .3 percent were in the top quartile in March 2016—99.7 percent of top funds didn't deliver top returns four years later. The inability of active managers to persistently best their peers and the market has been extensively studied and quantified. The diversified and low-cost portfolios we construct are scientifically engineered—we're not making bets on continued performance of any one fund. Instead, by investing in 12,000+ stocks around the world, we ensure that you receive the rewards you are entitled to and benefit from the growth in each and every sector, asset class, and country.

Negative Real Returns

Nominal interest rates are currently below zero in many countries, including Germany, Denmark, Switzerland, Sweden, and Japan. These levels have turned on its head the common belief that zero is the lower bound for such rates. While negative nominal rates are a relatively new phenomenon, periods of widespread negative real returns across countries have been quite common.

In 1970, a loaf of bread cost 25 cents. A gallon of gas cost 36 cents. Today, an average loaf of bread and a gallon of gas each cost around two dollars.[1] When the prices of goods and services increase, consumers can buy fewer of them with every dollar they have saved. This is called inflation, and it eats into investors' returns.

Real rates of return are adjusted for inflation, so they account for changes in the purchasing power of a dollar over the life of an investment. Because inflation affects the cost of living, investors must consider the inflation-adjusted—or real—return of their investments.

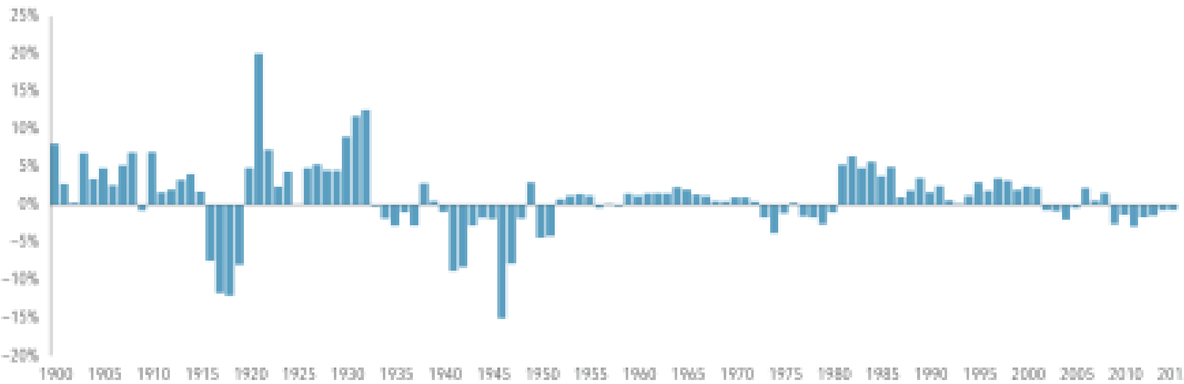
Exhibit 1 shows the annual real returns on one-month US Treasury bills. From 2009 to 2015, the annual real return was negative. This circumstance is not unprecedented. The US has had negative real returns in over a third of the years since 1900. And negative real returns on government bills are not exclusive to the US. All countries listed in **Exhibit 2** have had negative real returns on their respective government bills in at least one out of every five years from 1900 to 2015.

In the current low-yield environment, rolling over short-term bills may not seem appealing to investors keen on protecting their purchasing power. **Exhibit 3** shows that the return of one-month US Treasury bills has not kept pace with inflation[2] over the past 10 years. But even when the real return on bills is negative, a relatively common occurrence, bond investors may still achieve positive expected real returns by broadening their investment universe. The bond market is composed of thousands of global bonds with different characteristics. Many of those bonds allow investors to target global term and credit premiums, which in turn may provide positive real returns even in low-interest-rate environments. Exhibit 3 also shows that the Barclays Global Aggregate Bond Index has outpaced inflation while maintaining low real return volatility of 3.4 percent annualized over the past 10 years.

Global portfolios can also play an important role in the pursuit of increased expected returns. Even if the expected real returns of bonds in one country are negative, another yield curve may provide positive expected real returns. The flexibility to pursue higher expected returns by investing in bonds around the world can be an important defense against low, and even negative, yields.

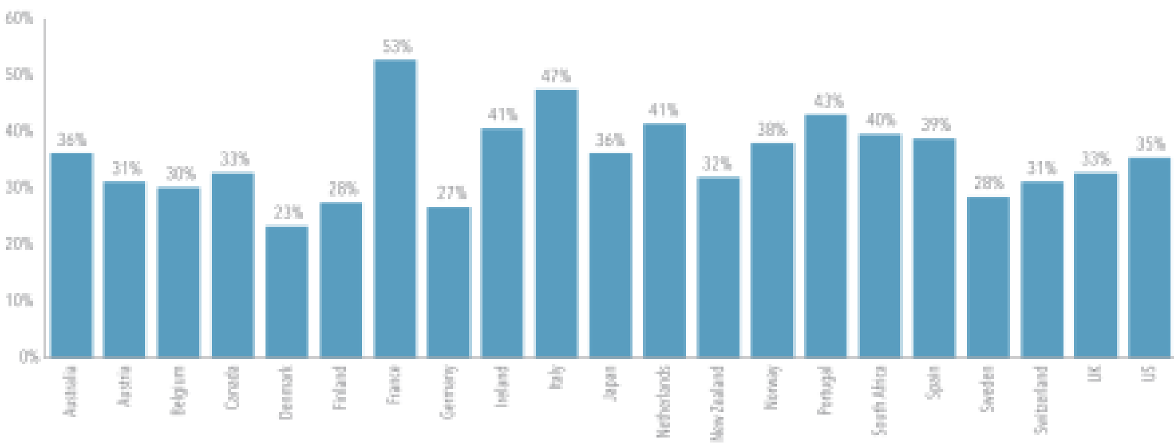
The goal of many investors is to grow some (or all) of their savings in real terms. Even in a low-interest-rate environment, there may be bond investments that can still achieve this goal. In particular, investors who target global term and credit premiums should be better positioned to pursue higher expected returns.

Exhibit 1. **Annual Real Returns of One-Month US Treasury Bills**



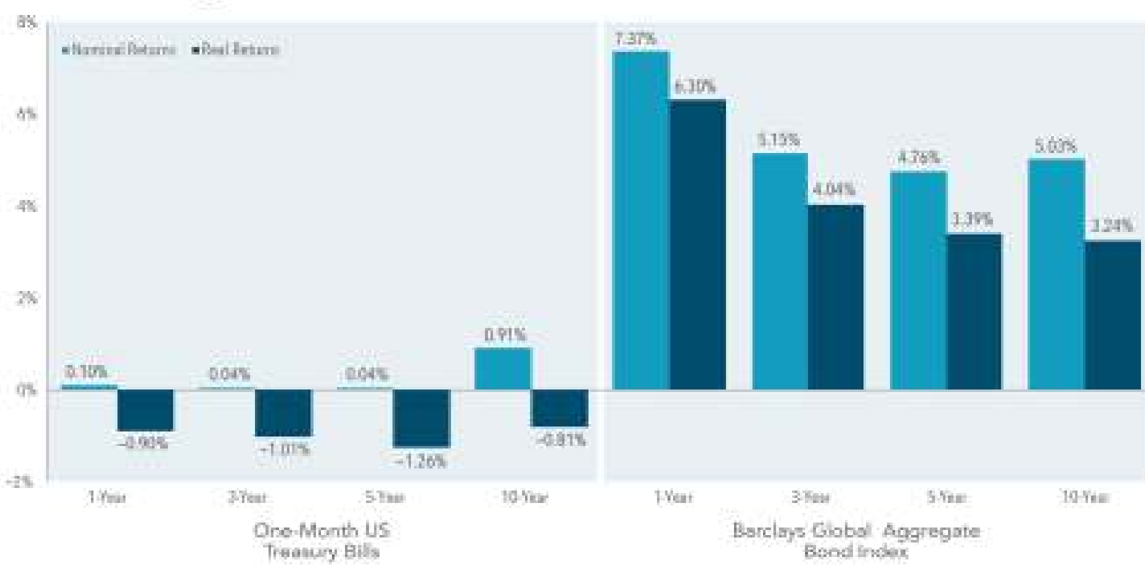
Source: Dimson, Marsh, and Staunton (DMS); Morningstar.

Exhibit 2. **Percent of Years with Negative Real Returns on Government Bills, 1900–2015**



Source: Dimson, Marsh, and Staunton (DMS); Morningstar.

Exhibit 3. **Trailing Annualized Returns**



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From Negative Real Returns:
1. Source: Bureau of Labor Statistics.
2. Measured as changes in the Consumer Price Index (CPI), which is defined by the US Department of Labor, Bureau of Labor and Statistics.