Understanding performance: The S&P 500 Index

Published: Feb 18, 2015 By Paul A. Merriman

From 1928 through 2014, the the S&P 500 index turned in 63 profitable years. (73% of the time)

Paul Merriman is committed to educating people of all ages to get the most from their retirement investments. Founder of Merriman Wealth Management, a Seattle-based investment advisory firm, he is the author of numerous books on investing: "Financial Fitness Forever," "Live It Up Without Outliving Your Money," and the new "How To Invest" series, free at his website: "How To Invest" series: "First Time Investor," "Get Smart or Get Screwed: How to Select the Best and Get the Most from Your Financial Advisor" and "101 Investment Decisions Guaranteed to Change Your Financial Future." In his retirement, Paul writes a weekly column atMarketWatch and continues his weekly podcast, Sound Investing, which was recognized by Money magazine as "the best Money Podcast in 2008". He is president of The Merriman Financial Education Foundation and all profits from the sale of his books are used to advance financial literacy. His recommendations for portfolios of Vanguard funds, Fidelity funds and ETFs, podcasts, articles and books are available at paulmerriman.com. Follow Paul on Twitter @SavvyInvestorPM.

PAUL'S LATEST POSTS

Buffett, Bogle, Merriman: Losers, every one?

- If you’re under 35, this is the ultimate all-value equity portfolio
- 25 things you should be getting from your financial advisor
- 9 retirement decisions that can change your future

Preparing to become a successful investor may be a bit like preparing to become a successful spouse.

- Marriage is supposed to be for the long term, but many don't last very long.
- Investing is supposed to be for the long term, but many investors sell their carefully chosen assets because of short-term disappointments.

In both cases, there's the courtship, the honeymoon and the reality.

My job is to help you find — and stick with — investments that will satisfy you and make your life better over the long term.

This article is the first in a series focused on the performance of the asset classes I recommend. In each case I will cover the courtship and then spend considerable time on the reality of what you should expect when the honeymoon is over.

We start with the Standard & Poor's 500 Index **SPX, +1.26%** a mixture of growth stocks and value stocks that's the bedrock of most people's portfolios.
Along with its near-twin, the Total Stock Market Index **DWCF, +1.24%** I believe the S&P 500 represents the majority, perhaps even 60%, of all U.S. equity mutual fund and ETF holdings. As an asset class, this is called large-cap blend.

UNDERSTANDING PERFORMANCE

Join Paul Merriman in this series designed to help you better understand market performance and how to get better returns with less risk than the Standard & Poor's 500 Index.

• 10 things to know about portfolio performance
• The S&P 500 Index • Large-cap-value stocks
• Small-cap stocks • Small-cap-value stocks
• Four-fund strategy • Performance Q&A
• Real-estate investment trusts
• Target-date funds • TDFs: Fidelity vs. Vanguard
• Six reasons to invest internationally
• Int'l large-cap blend • Int'l large-cap value
• Int'l small-cap blend • Int'l small-cap value
• Emerging markets • Ultimate Equity Portfolio

Consider the "courtship" for a moment. In theory, most people could achieve their long-term investment goals with nothing more than an S&P 500 Index fund that lets them own shares in about 500 large, well-respected U.S. companies.

From 1928 through 2014, the S&P 500's compound rate of return was 9.8%, enough to transform a $100 investment at the start of 1928 into $346,261 over 87 years.

Given enough time, such a return would almost certainly be sufficient to fund a comfortable retirement.

Looking through the eyes of a young investor with 40 or more years ahead, I studied every 40-year period during that time (there were 48 of them). The worst performing period yielded a compound return of 8.9%. The best was a compound return of 12.5%.

Either one those returns should be adequate, if not ample, for most long-term investors who are good savers.

A brief detour: Even though the compound return over 87 years was 9.8%, the average return of all those 40-year periods was 11.8%.

Average returns, often a popular selling tool used by brokers and commission-based investment advisers, may sound good. But investors don't actually get average returns; they get compound returns.

For example, if you invest $1,000 and it goes up 50% in the first year and then drops by 50% the second year, the average return was zero — leading some people to think you broke even. But you didn't.

At the end of the first year you had $1,500; at the end of the second year you had only $750. That's a cumulative loss of 25%, or a compound loss of 13.4% a year.

My advice: Ignore average returns. Instead, focus on multiyear compound returns.

So, the 40-year returns of the S&P 500 are favorable.

However, because not everybody has a 40-year investment horizon, I analyzed all the 15-year periods from 1928 through 2014 (there were 73 of them).

The S&P 500's highest 15-year performance, a compound return of 18.3%, came in 1985 through 1999. The lowest, a barely positive return of just 0.6%, was from 1929 through 1943. Ouch!

About six of every 10 of these 15-year periods produced returns over 10%, and the rest fell below that mark.

You may have noticed that the difference between the best and worst 15-year periods was much greater than the difference between the best and worst 40-year periods. This is no surprise: The longer you hold an asset, the closer its compound return is likely to be to the mean.

I know full well that many fund managers, brokers and investors lack the patience to wait for 15 or 40 years to achieve results. So I used a third time frame to look at the S&P's historical returns: One year.

From 1928 through 2014, the index turned in 63 profitable years, with an average gain of 21.5%. However, 24 years were negative, with an average loss of 13.6%.

- The good news: Winning years easily outnumbered losing ones, and the average wins were bigger than the average losses.
- The bad news: Investors didn't get to choose in advance which sort of years they would experience.

Unfortunately, the only way to be sure you'll reap the rewards of the good years is to endure the punishment of the bad ones. That can be emotionally very challenging.

One-year performance was all over the map, from a high of 54% in 1933 to a low of minus 43.4% in 1931. Lest you think that shocking loss was merely a one-time anomaly, the index later dished out three cumulative top-of-the-market to bottom-of-the-market losses of more than 50% in 1973-1974, in 2000-2002 and again in 2007-2009.

Unfortunately the bad years can stack up together. Three times since 1928 the S&P 500 Index turned in three or four consecutive calendar-year losses.

Every time, there was a sense that the whole economic system was coming unglued without any obvious fix. Every time, the market recovered.

In this article I have focused on some unpleasant facts so that you will know that it's normal for any asset class to have extended periods of disappointment.

But don't give up. During many of the rough years for the S&P 500, other historically productive asset classes did fine. For more on this index, check out my podcast The Myths and Realities of the S&P 500.
The next article in this series will investigate U.S. large-cap value, an asset class that can be very different from the S&P 500 and considerably more profitable over the long haul.

Richard Buck contributed to this article.

MORE FROM PAUL MERRIMAN

How does the retirement expert spend his retirement?

By helping others with theirs. More articles from author, educator and financial expert, Paul Merriman.