Does One Percent Matter?

By Daniel G. Head

As a child I remember hearing my grandmother say, "it's the little things that really matter." In the context of investing, many would regard one percent as "a little thing." Could one percent really make a difference?

For perspective, over the past 20 years, the Dow Jones Industrial Average (aka "the Dow") rose from 9,184 to 23,327. Simply bumping that average by one percent annually would have translated to nearly 5,000 additional points! A one percent annual reduction in performance would translate to a level below 20,000 — a hurdle the index cleared in late 2016.

However you slice it, it's difficult to escape how trivial one percent may seem. A return of 0.004 percent each trading day across a year hardly seems earth-shattering! The first two sections below are designed to remind us of age-old truths — whether accumulating or withdrawing, a single percent is a big deal. The third section speaks to the potential Game Changer, illustrating how one percent of value-add could allow one to pursue a much different path to meet a target return objective.

One Percent During Accumulation

The compounding effect of money, as Einstein asserted, is the eighth wonder of the world. It's one of the most basic tenets of finance and often unappreciated by the masses. As the chart below illustrates, both the scale of return and the duration of investing are critical. For example, the one percent difference between 5.5 percent and 6.5 percent returns over thirty years results in a 21 percent difference in accumulated wealth. Few would suggest that sum inconsequential.

	5.0%	5.5%	6.0%	6.5%	7.0%
Year 10	$148,357	$152,916	$157,625	$162,487	$167,508
Year 20	$373,726	$397,038	$421,999	$448,726	$477,349
Year 30	$740,827	$814,034	$895,452	$986,036	$1,086,853

* $10,000 annual savings, compounded annually

One Percent During Distribution

While one percent can make a substantial difference during the accumulation phase, it is even more critical during the distribution phase. As the graph below illustrates, one's standard of living can be substantially altered by a one percent performance difference. As the highlighted areas illustrate, assuming static returns, a one percent difference equates to over $200,000 more distributions from the same accumulated sum. Whether individual, foundation, or corporate entity, that difference scales quite meaningfully.

		Years of Distribution		
		25	30	35
Growth %	3.5%	$4,855	$4,351	$4,001
	4.0%	$5,111	$4,618	$4,278
	4.5%	$5,373	$4,891	$4,563
	5.0%	$5,640	$5,171	$4,855
	5.5%	$5,913	$5,458	$5,154

* $1 Million initial investment, assuming 2.5% inflation

The 60/40 Blend

In 1982, Wilshire Associates, one of the most trusted investment consultants in the world, projected a 60/40 portfolio would return over one percent per annum. By 2003 that figure had fallen below 7.5 percent and today it sits below 7 percent. That same 60/40 investment portfolio (60 percent S&P 500 and 40 percent Barclay's Aggregate Bond Index) over the last 20 years produced a 5.86 percent annual return.

A 40/60 portfolio over the same 20 years would have garnered a 5.35 percent return with two thirds of the volatility of its riskier counterpart. As we earlier asserted, however, that 0.51 percent annual difference (5.86 - 5.35) isn't trivial! Equally untrivial was the difference between the -20.1 percent loss by the 60/40 blend in 2008 when compared with a lesser -11.7 percent loss by the 40/60 portfolio.

Herein lies the dilemma investors, both retail and institutional, face today — how to deploy capital in such a way that meets both return needs and do so within acceptable risk parameters. The reason investors allocate to equities is for a greater expected reward than bonds and for greater liquidity than most alternative solutions. In a low interest rate environment characterized by modest global growth and leveraged government balance sheets, finding the right balance proves difficult.

Change the Game with One Percent

For a moment, let's assume that an investor finds a way to generate one percent of additional return annually above that of the indices. In other words, if the 60/40 portfolio returned 10 percent, this portfolio would have generated one percent more.

What would that allow an investor to do? Aside from considering it "found" money, a prudent investor would likely use this as an opportunity to reduce risk exposure. After all, the most predictable and least volatile way to achieve the targeted return with stocks and bonds is with the greatest percent of assets in fixed investments, e.g.,bonds.

As the chart below illustrates, over the last 20 years, an investor achieving that additional one percent per year would have garnered a 6.53 percent annualized return with only two down years (-1.68 percent in 2002 and -10.66 percent in 2008). The 2000-2008 stretch that decimated many financial plans would have produced a respectable 3.79 percent per annum.

		Bonds	Stocks	60/40 Blend	40/60 Blend + 1% Value Added
1999-2018	Return	4.54%	4.60%	5.62%	6.53%
	Standard Deviation	3.70%	17.48%	9.89%	6.14%
2000-2008	Return	6.03%	-3.61%	0.88%	3.79%
	Standard Deviation	3.53%	20.32%	11.41%	7.07%
* Illustrated with Barclays Aggregate Bond Index (bonds) and S&P (stocks)					

Why Does This Matter Today?

From Jeremy Grantham to CalPERS, the lists are long of accomplished investors whose outlook for equities are modest (or even bleak). Only time will tell whether their projections are correct.

The 60/40 portfolio in Q4 of 2018 would have lost three percent more than its 40/60 counterpart. As volatility surged, global equity markets sold off, and the Santa Claus rally failed to arrive, investors were left to contemplate whether the Bull market was over. To many investors, that three percent difference could have been the difference between reaction and resilience. After all, resilience is far easier when losses occur less often and more contained.

Many investors today seek a return on the order of magnitude of six to seven percent per annum. With capital market assumptions for U.S. equities hovering around seven to eight percent and fixed income closer to three percent, that creates a mathematical challenge:

- With a generous eight percent for Equities
- 60 percent stocks/40 percent bonds return is six percent
- To reach a target of seven percent, an 80/20 mix is required.

To use the earlier illustration, adding one percent to the portfolio is essentially the same as turning the eight percent and three percent assumptions into nine percent and four percent. With these revised assumptions, a 40/60 portfolio would generate six percent and a 60/40 mix would project seven percent. In other words, a 20 percent smaller allocation to equities would have garnered the same return with less volatility!

An additional one percent per annum not only allowed for a less stressful Q4 of 2018, but also outperformed over the last 20 years. That small and seemingly insignificant sum could represent the gap between what is needed and what's projected.

One percent doesn't just matter — it's a game changer!

A native New Yorker, Daniel is a proud father of two with nearly four decades experience in the securities industry. Throughout his career, Daniel has been an innovator. His most memorable moments center around navigating the uncertain times for anxious clients, from the Crash of '87 to the Financial Crisis.