Risk- and Inflation-Adjusted Returns

I recently read a memo titled The Indispensability of Risk from Howard Marks of Oaktree. In it he quoted himself from a previous memo titled Fewer Losers, or More Winners?

…not having any losers isn't a useful goal. The only sure way to achieve that is by not taking any risk. But … risk avoidance is likely to result in return avoidance. There's such a thing as the risk of taking too little risk. Most people understand this intellectually, but human nature makes it hard for many to accept the idea that the willingness to live with some losses is an essential ingredient in investment success.

As Howard mentions, most of us can understand this, but sometimes when we see the negative returns for certain investments on our statements it makes it more difficult to accept. In any diversified portfolio there are always going to be winners and losers from year-to-year.

Speaking of risk, Meb Faber, founder of the Cambria Funds, recently posted some interesting data tracking various assets from 1926-2022.

Real Returns After Inflation 1926-2022	Cash Under Mattress	Cash T-bills	US Stocks	Foreign Stocks	10 Year Bonds	Gold
Annualized Returns	-2.94%	0.36%	6.85%	4.61%	1.82%	2.00%
Volatility	1.82%	1.82%	18.80%	16.04%	7.17%	14.99%
Max Drawdown	-94.22%	-48.91%	-79.18%	-78.01%	-60.63%	-84.39%
% Positive Months	36.34%	60.82%	59.97%	57.04%	53.61%	41.49%
Worst 1 Year Returns	-16.90%	-16.58%	-63.95%	-56.75%	-24.69%	-42.24%
Worst 3 Year Returns	-28.90%	-25.33%	-76.08%	-64.07%	-34.87%	-50.76%
Worst 5 Year Returns	-38.18%	-28.11%	-51.70%	-76.33%	-38.62%	-67.42%
Worst 10 Year Returns	-57.24%	-42.29%	-45.45%	-70.89%	-44.43%	-65.24%

SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

As you can see from these real returns, meaning they have been adjusted for inflation, US Stocks aren't the only asset class that can have large drawdowns over 1, 3, 5 and 10 year periods. T-Bills and 10-year bonds have had some substantial drawdowns over those time periods, mainly do to the impact of inflation on their nominal returns. This is important to think about today when we see yields on CDs, money market accounts and bonds of various maturities in the 5% range. What may seem like a great risk-free return today may not be so after adjusting for inflation years from now.

Real Returns After Inflation 1926-2022	Cash T-bills	US 60 / 40	GAA
Annualized Returns	0.36%	5.28%	4.64%
Volatility	1.82%	11.92%	8.40%
Max Drawdown	-48.91%	-53.79%	-33.96%
% Positive Months	60.82%	58.93%	63.40%
Worst 1 Year Returns	-16.58%	-43.26%	-15.37%
Worst 3 Year Returns	-25.33%	-49.30%	-22.98%
Worst 5 Year Returns	-28.11%	-26.33%	-15.79%
Worst 10 Year Returns	-42.29%	-31.69%	-18.18%

SOURCE: Global Financial Data, Meb Faber as of 12/31/22. Performance is hypothetical.

Not surprisingly, the best risk-adjusted portfolio over the period Meb studied was a globally diversified one. This is why we stay globally diversified despite US returns recently being substantially better than international, emerging and frontier markets. As Howard Marks discussed, we take those drawdowns now so that over time we generate the best risk and inflation adjusted returns that we can in our portfolios.

As always if you have any questions please don't hesitate to reach out.

Best,

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