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Understanding the Myth of the Lost Decade

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A lot has been written with more to come about the lost decade for equity investors. While it is true that the S&P 500 lost about 10.0% and the government bond market gained 81.82% from 2000 through 2009, the performance profile is lopsided and understates larger discrepancies occurring in other asset classes.

However, before looking at the bigger picture, it is important to break down the returns of the past decade into two time periods: 2000 through 2002, and 2003 through 2009. During the first period, equities lost 37.59% while the bond market gained 35.0%. The strong performance from the government bond market was largely due to the flight to quality following the collapse of the dotcom bubble and the 9/11 terrorist attack in the US. These events forced the Federal Reserve to push the Federal Funds rate down to 1 percent.

During the following seven years, equities and government bonds gained 42.9% and 34.7% respectively. Importantly, during this period, the total return from the bond market was entirely due to interest income. Government bonds were actually down 1% in price over the same period. Conversely, the price return generated from the equity market was 24.5% over this period.

The biggest story about the lost decade is the complete dominance of emerging market equities. The MSCI emerging market index gained 102.4% during this past decade, a significant difference compared to the 10% loss by the S&P 500 over the same period.

The absolute outperformance of emerging market equities over domestic US equities is a continuation of the outperformance from the preceding decade, when the MSCI emerging market index gained 2,408% versus a respectable gain of 432% for the S&P 500. During the 1990s, the government bond market produced a total return of 105.3%, of which only 2.1% was earned from capital appreciation.

Over the entire 20 year period (1989 - 2009), emerging market equities produced an annualized return of 21.7% compared to just 8.1% annualized for the S&P 500. The bond market returned 6.8% annually over this same period of which a very meager 0.70% was attributed to price improvement.

Clearly a key take-away from the return data is that, over long periods of time, returns from the bond market are generally produced from the compounding of interest income rather than from price appreciation.

The discussion over the lost decade of equity returns should not center upon how US stocks have underperformed the US bond market; rather, it should focus on how the S&P 500 underperformed emerging market equities over not just the last 10 years, but over the past 20. The highlight of the last 20 years has been the emergence of emerging market equities as a viable asset class. Moreover, the impressive return of emerging market equities happens to correlate with the near 13-fold increase in China's GDP from $343.9 billion in 1989 to $4,326 billion in 2008. China is now the third largest economy in the world and its GDP is less than $500 billion away from becoming the world's second largest economy. By comparison, the US economy has expanded by just 2.6 times over the past 20 years. Brazil's economy expanded from $425.6 billion in 1989 to $1,612.5 billion by the end of 2008. Meanwhile, Germany's economy expanded 2.7 times while India's GDP more than quadrupled from a GDP of $292.9 billion to $1,217.5 billion over the same time period.

Over the past 10 years, emerging economies have recorded explosive growth as compared to their developed counterparts. For example, for the decade just ending, Japan expanded by $541 billion, Germany by $1,509 billion, and the US by $4,988 billion. Collectively, the three largest economies of the past decade have expanded by $7,038 billion. Conversely, the economies comprising the BRIC countries have nearly equaled the expansion of the three largest developed economies by adding $6,448 billion of economic wealth in total.

Even more impressive is the fact that the combined GDP gap between the top three developed economies (US, Japan and Germany) and the BRIC economies has shrunk from 6.8 times to only 2.6 times today. The narrowing of the economic divide between developed and developing countries helps to explain the outperformance of emerging market equities versus the S&P 500 over the past 10 and 20 year periods. More broadly, emerging market equities have also outperformed **all** developed markets over the past 10 and 20 year periods.

In summary, analysis of the lost decade needs to move away from simply looking at relative US-centric market performance and focus on the more significant trend - the rapid convergence of emerging market economies towards the fully developed ones. It was truly impressive to watch China's GDP leap ahead of Germany, France and the UK over the last 10 years. With little effort, China will move ahead of Japan to become the second largest economy in the world and will somehow still be considered an "emerging economy."

Total Returns

	12/31/89 - 12/31/99 (%)	***12/31/99 - 12/31/09 (%)***	***12/31/89 - 12/31/09 (%)***
Government Bond Market	105.3	81.8	273.33
S&P 500	432.0	-10.0	374.38
MSCI Developed	141.2	-25.4	79.82
MSCI Emerging	2408.6	102.4	4977.6

Source: *Bloomberg*

The expected returns for the next decade will likely be determined by whether the GDP gap between developed and emerging countries continues to narrow. It is our view that during the next 5 years, China will surpass Japan to become the second largest economy in the world. The continued growth of a larger middle class in developing regions combined with the further penetration of electronic communications will allow emerging markets to outpace the developed markets, once again, in the years to come.

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