"Achieving Successful Outcomes"

Compound Interest

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THE ROLE OF STOCKS & BONDS IN A BALANCED PORTFOLIO

In our previous Compound Interest series posts, we have discussed the concept of a Liquidity Bucket. This practice allows investors to protect their portfolio's ability to consistently provide for spending needs and avoid liquidating stocks when they are temporally down in value. As explained in our previous piece, owning investment solutions that provide a stable and growing stream of income is one of the most powerful components in a successful long-term investment program.

It is common knowledge that $1 million invested over a ten-year period can enjoy the benefits of compounding. And of course, how the $1 million is invested will have a disproportionate impact on the terminal value. While it makes sense that a higher-returning investment would generate higher profits, what many do not understand is the extent to which compounding magnifies profits at higher rates of return. For example, 10% is only 2 times 5%, but a 10% annualized return will generate over 2.5 times the profit of a 5% annualized return.

Returns without Inflation

Initial Value	Rate of Return	Time Period	Total	Profit
$1,000,000	10%	10 Years	$2,593,742	$1,593,742
$1,000,000	5%	10 Years	$1,628,894	$628,894

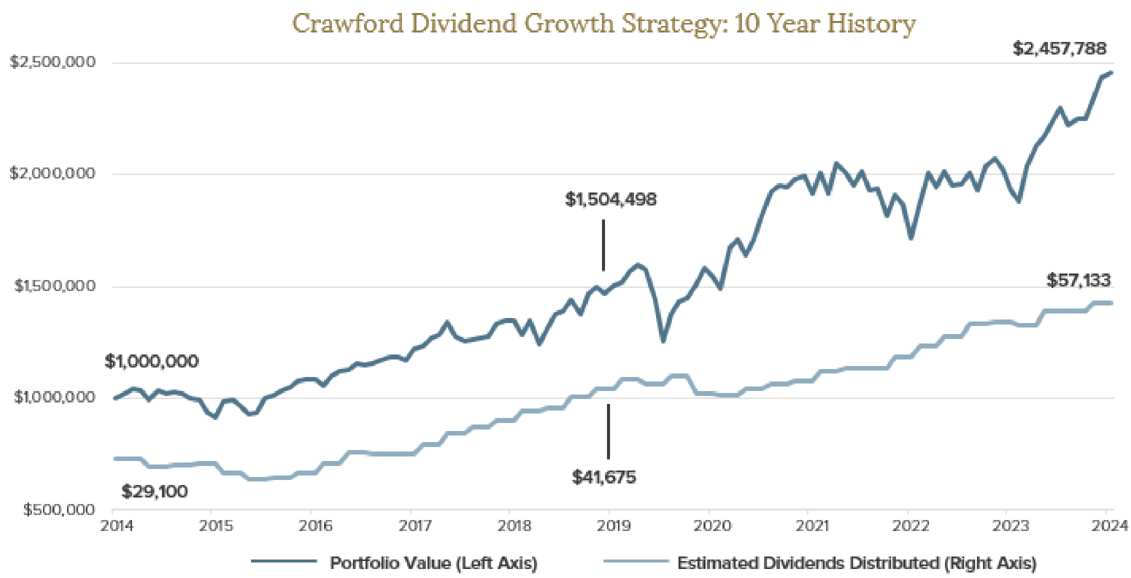
As we have been reminded in recent years, inflation is a variable that investors are unable to control. Its impact on future purchasing power will have a meaningful impact on the ultimate success of any investment program. However, the lower the return, the more disproportionate and magnified the effect of inflation becomes. Using the example above, if inflation is 3% over the 10-year period, the real profit generated from $1 million invested with a 10% return is actually 4.4 times greater than the real profit earned at 5%.

Returns with 3% Inflation

Initial Value	Rate of Return	Time Period	Total	Profit
$1,000,000	10% - 3% = 7%	10 Years	$1,967,151	$967,151
$1,000,000	5% - 3% = 2%	10 Years	$1,218,994	$218,994

As a fiduciary, we must not lose sight of this concept when constructing portfolios. Clients who are attracted to our investment approach typically have two primary objectives. First, to utilize their portfolio to provide for their current and/or future spending needs. And second, to grow the real value of the portfolio as it relates to legacy planning. Because our equity strategies seek to obtain a rising stream of income, our approach is well suited to helping investors achieve these objectives.

To place actual figures around the concepts, it is helpful to gain some historical perspective. At Crawford, we have been managing our Dividend Growth strategy for 43 years. All stocks held in the portfolio pay a dividend, and we have a strong preference for stocks that demonstrate a long history of growing their dividends. Based on historical performance, a $1 million investment in the Dividend Growth strategy 10 years ago would be worth $2.4 million today, earning an annualized return of 8.92% (net of fees). More importantly, in the first year of holding that investment, the strategy generated $29,100 in dividend income. Today, that investment is expected to generate annual dividends of over $57,000. This reflects a 6.98% annualized growth rate in the income and a 5.71% yield on cost. This example assumes dividends were reinvested back into the portfolio.



	Returns (Net of Fees)	Growth of Income	Yield on Cost
3-Year	8.22%	9.90%	2.99%
5-Year	9.79%	6.51%	3.80%
10-Year	8.92%	6.98%	5.71%

1-Year Returns (Net of Fees) for the strategy are 26.83%. Data as of 9/30/2024. Source: Crawford, eVestment. Data is presented net of fees. Net of fee performance is calculated based on the actual fees experienced. Past performance is not indicative of future results. The composite returns are shown as supplemental information to the Dividend Growth composite disclosures which are linked in the disclosures. The above chart is based on a $1,000,000 investment in the Dividend Growth strategy 10 years ago; portfolio value reflects the growth based on the returns for the Dividend Growth composite with dividends reinvested back into the portfolio. The Estimated Dividends Distributed reflects the Portfolio Value multiplied by the current yield of the respective strategy at quarter end.

Owning a portfolio of companies that regularly increase their earnings and dividends is a powerful force. In the period evaluated, investors endured higher-than-normal inflation. Inflation, measured by CPI, was roughly 2% when the investment was initiated. However, in the aftermath of Covid, inflation moved to levels not seen in the last 35 years. Only until recently has inflation come back down to the 2.5% range. On a cumulative basis, prices are up 27.4% (3% annualized). Fortunately, the Dividend Growth strategy has seen both the value of the investments and dividends appreciate at a rate well above inflation. In real dollars, the investor has far more assets and income today than when they initiated the investment.

However, not all investors can own a portfolio of 100% stocks. This is why we utilize a Liquidity Bucket with some investors to help ensure their needs are met. Bond investors need to factor in the impact of inflation, as the future value of any investment will decline in current dollars by whatever the inflation rate is over the holding period. Typically, a bond investor receives what they paid for the bond when it matures, along with a constant stream of interest income. The greater certainty of cashflows has allowed bonds to be one of the most effective ways to diversify the risk of owning stocks. Their ability to preserve capital in poor economic/market conditions makes them an excellent source of liquidity when stocks are down in value. At the same time, we caution long-term investors to be careful when establishing asset allocation parameters to make sure the portfolio has the ability to both generate a reasonable level of income and, more importantly, to grow its income and principal value at a rate in excess of inflation.

We find many investors tend to be overly conservative and fail to play the long game. Exploiting a higher rate of return has a disproportionately positive benefit to a portfolio's value as the time horizon expands. At Crawford, for over 40 years, our investment approach has allowed investors to allocate more to the higher-returning asset class as our equity strategies attempt to hold a lower level of overall risk. The ability to grow the long-term value of the portfolio while also growing the income is a powerful force helping clients to achieve successful outcomes.