

The Importance of Long-Term Perspective in Investing

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Stay calm and focused during market downturns by understanding long-term averages.

Robert Powell: How should investors think about long-term averages? Here to talk with me about that is David Shotwell, a financial planner with Shotwell Rutter Baer. David, welcome.

David Shotwell: Thanks, Bob. How are you today?

Powell: I'm great, and I'll be even better after you walk us through how investors need to think about long-term averages.

Shotwell: In the investment world, we're bombarded with statistics. It's common for people to look at past performance and try to extrapolate different comparisons. Newer clients often look at a portfolio and see one thing's down, one thing's up, and question why we're keeping certain investments.

We try to help people think about what we can learn from long-term returns. First, if your portfolio is diversified, there's always going to be something that isn't performing as well as everything else. That's the nature of diversification.

We frame the conversation that if the market's been doing very well, your portfolio should be doing well. What's important is to consider: if my portfolio is up 12% this year, but the long-term average for a portfolio like mine is 8%, what does that tell us about the future? If long-term averages hold true, and they tend to over time, we've got to expect some downside if we've seen outperformance for a while. It's about keeping that perspective.

Powell: When thinking about investing, consider the historical averages. For the long-term, small-cap stocks have done 12% on average since the late 1920s, and large-cap stocks have done 10%. A balanced portfolio of 60-40 might be somewhere between 6% and 8%. Most people don't have 100% of their money in equity, so it's almost the wrong comparison to say, "My return was 8%, but the long-term average of small caps is 12% or

10%.” When you talk to investors and your clients, do you have to frame it in the sense that we need to look at our portfolio as it’s allocated, not comparing it to the S&P or NASDAQ?

Shotwell: Absolutely. You’ve got to make sure you’re doing an apples-to-apples comparison. Most of our clients end up with what we call the 60-40 portfolio, the “Goldilocks portfolio.” If you’re 40% in bonds and 60% in stocks, comparing yourself to the long-term average of large-cap stocks isn’t going to be very meaningful.

What you want to look at is the weighted average return. To keep it simple, I like to use 10% for the portion in stocks and 5% for the portion in bonds. Yes, if you’ve got small company stocks and international stocks, it’s going to vary from that a little bit, but don’t let those details bog you down too much.

Powell: In the article you wrote for Retirement Daily, you mention that while people are often told past performance is no guarantee of future results, you have the opinion that the average can tell you a little bit about what the future holds in store.

Shotwell: Right. The 10% average return for the stock market at large goes back through the entire history of the stock market, including good times, bad times, and everything in between. If you follow that back and think about the fact that it seems to hold true based on the economic growth of the world, then unless something has really changed in the dynamic, we can expect similar patterns.

If your stock funds are up 20% and the long-term average is 10%, at some point it’s going to underperform that. And vice versa, if we’re in the middle of a nasty market and you’re down 15%, you can take comfort in the fact that we’re likely to have a couple of good years where we make that up.

Powell: Let’s talk about the notion of outperforming the historical average and the possibility that people may say, “Let’s take money off the table and liquidate my portfolio.” Can you elaborate on that?

Shotwell: While there’s predictive power in the sense that at some point we will see reversion to the mean, it doesn’t tell us when or how. If you’re seeing outperformance, getting back to the mean might mean a couple of blah years where it just doesn’t live up quite to the averages. It can also mean one really bad year that we all get dizzy from, and then it’s over.

There’s an old cliché in the markets that “the markets can stay irrational a lot longer than you can stick with it.” Just because we’re seeing outperformance doesn’t mean you’re ever going to be able to tell when that change is going to happen.

Powell: I often receive expected rates of return for the next seven or ten years from major investment firms. In some cases, they're dramatically lower than the historical averages. Do you place any weight on these kinds of predictions?

Shotwell: Without specifics, it's hard to say, but I always take those with a grain of salt because they generally are all over the map. At any given point, you can find different predictions that sound logical and reasonable based on very good assumptions, and they'll be completely different. The best thing to do if you're going to make a prediction is make it loud and make it often.

Powell: And if you're wrong 50% of the time, you're at a pretty good average. I always say Ted Williams got into the Hall of Fame with a .400 batting average. So if you're right half the time, that's pretty good in this world.

Shotwell: I think most macroeconomists would be thrilled with a .400 average.

Powell: Is there anything we missed as we think about how investors should think about long-term averages?

Shotwell: Just keep in mind that long-term averages are probably as good as you're going to do as far as prediction goes. In the short run, who knows what the market's going to do tomorrow? There'll be global headlines and economic headlines we don't know about ahead of time, and the market will react. But when you take that and run it out over time, patterns emerge that, while they don't tell us magnitudes and timing, do tell us where we should end up over the long run.

Powell: David, I so appreciate you writing for Retirement Daily and speaking with us in these videos where you share your knowledge and wisdom with our viewers and listeners. Thank you very much.

Shotwell: I appreciate the opportunity, Bob. Thank you.
