Insight: Long-term stocks win through

By Jeremy J. Siegel

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The recent bear market has been particularly painful for stocks investors, beginning only five years after the vicious 2000-2002 bear market. For the ten years ending last December, stocks have offered a negative 3.15 per cent real return for US investors, constituting the fourth worse ten year period since 1871. This had led many to question whether the mantra “Stocks for the Long Run,” is still right for investors.

But a look at history shows that recent experience is not uncommon and excellent returns are available to those who survive such rough patches. Since 1871, the three worst ten-year returns for stocks have ended in the years 1974, 1920, and 1978. These were followed, respectively, by real, after-inflation stock returns of more than 8 per cent, 13 per cent, and 9 per cent over next ten years. In fact for the 13 ten-year periods of negative returns stocks have suffered since 1871, the next ten years gave investors real returns that averaged over 10 per cent per year. This return has far exceeded the average 6.66 per cent real return in all ten years periods, and is twice the return offered by long-term government bonds.

Strong future returns also followed poor returns if one extends the analysis to the worst-performing of all 127 10-year stretches since 1871. Without exception, for each ten-year return that fell in the bottom quartile, the following 10-year period yielded positive real returns and the median return exceeded the long-run average.

Stocks also swamp the returns on fixed-income assets over the long run. Even with the recent bear market factored in, stocks have always done better than Treasury bonds over every 30-year period since 1871. And over 20-year periods, stocks bested Treasuries in all but about 5 per cent of the cases.

Last March, at the very depth of the bear market in stocks, Robert Arnott, Chairman of Research Affiliates, caused quite a stir by indicating that over the past 40 years, investors rolling over in non-callable 20-year US treasury bonds slightly outperformed stocks. Indeed, at the end of March of this year, the annual returns on long-term treasuries did outpace stocks over the last 40 years, 8.90 per cent to 8.71 per cent.

While the stock return was below its long-term average, the return on treasury bonds was well above average. Indeed to obtain those bond returns over the next 40 years, yields on long-term US treasury bonds would have to fall to about 2 per cent, an exceedingly unlikely scenario. In fact, with the recent stock market recovery and bond market decline, stock returns now handily outpace bond returns over the past 30 and 40 years.

The excellent historical returns on stocks are not limited to the United States. Three UK economists, Elroy Dimson, Paul Marsh, and Mike Staunton have examined the historical stock and bond returns from sixteen countries since 1901 and published their research in a book entitled, Triumph of the Optimists: 101 Years of Global Investment Returns.

Despite the major disasters visited on many of these countries, such as war, hyperinflation, and depression, all 16 countries offered substantially positive after-inflation stock returns and the superiority of equities over fixed income assets was decisive in all countries examined.

The authors conclude "Concerns about survivorship bias [by examining only US data] may be overstated [and] investors may have not been materially misled by a focus on the US."

Bill Gross, the head of PIMCO, has joined other pessimists by claiming the US economy is headed for a "New Normal," which he describes as slower economic growth and limited stock returns. This prediction is based on lower spending by American consumers who are unwinding from the excess leverage built up over the past decade.

But these predictions fail to take into account that it is world economic growth, not only US growth, which will dictate future stock returns. Every dollar of US international indebtedness is matched by a dollar of assets abroad. S&P 500 companies now obtain almost 50 per cent of their revenue outside the US and that share will most certainly rise as growth in the emerging nations continues to outpace that of the developed world.

Finally, US stocks are cheap compared to forecast earnings. For the S&P 500 index, stocks are now selling for about 14 times projected operating earnings for 2010. Since 1955, stocks have sold at an average 18 to 20 times earnings when interest rates and inflation are low, such as now.

The recent behaviour of stock market prices sheds some light on a phenomenon which has long puzzled economists: why do stocks over the long run yield so much more than bonds? The pain that investors often suffer, such as in the recent bear market, forces many to forsake equities altogether. This drives stock prices down and enhances their future returns. Equities offer investors excellent returns to those willing to accept the market's volatility.

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