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## Back To Basics: Realistic Expectations

The outstanding stock market returns in 1995 and the generally benign financial markets over the last 14 years seem to be leading to widespread unrealistic expectations regarding returns on investments. We have had a number of new prospects indicate that they expect annual returns of 15 percent or more on balanced portfolios. A distressing number of market pundits are suggesting that long term annual returns of 30 percent or more are reasonable. A \$100,000 investment compounding at 30 percent for 30 years grows to \$262 million, which should be adequate for even the most profligate retiree. Hmmm. Let's pause, take a deep breath, and actually think about this a bit.

The bible of this century's historical returns from investments is the Stocks, Bonds, Bills and Inflation Yearbook published by Ibbotson Associates. The 1996 Yearbook tells us that the average annual total return from large company stocks, as measured by the Standard & Poor's 500 average, was 10.5 percent in the 70 years since 1925. Long term corporate bonds had a total return of 5.7 percent. Adjusted for inflation, the average annual total return from large company stocks and long term corporate bonds was 7.2 percent and 2.5 percent, respectively. Based on history, a balanced portfolio 60 percent invested in stocks and 40 percent invested in bonds has an expected return of 5.3 percent after inflation but before taxes and expenses.

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Many investors find these numbers shockingly low. After all, the average annual total return on the S&P 500 was 16.36 percent for the 14 years ended in 1995, and the most recent 5 years showed an even higher return. The historical average, however, includes periods of relatively good performance (like the last 14 years) and periods of relatively bad performance. At the end of 1974, the post-1925 average annual total return on the S&P 500 was 8.4 percent. The current 10.5 percent long term average total return from the S&P 500 is the highest the long term average has hit since 1930. Even if the total return on the S&P 500 was *zero* for each of the next 16 years, the post-1925 average annual total return on the S&P 500 would still be above the 1926-1974 level.

The last time the long term average annual total return on the S&P 500 was near current levels occurred in the mid-1960's, when the popular media were filled with stories about the financial markets being in a "new era" of permanent prosperity. Subsequent market performance dashed these hopes as the inflation-adjusted average annual total return for the S&P 500 for the six years ended in 1974 was a *negative* 9.3 percent. The Dow Jones Industrial Average first reached

the 1000 level in January 1966 but did not decisively break through the 1000 “barrier” until 17 years later. The Dow Jones Industrial Average declined 36 percent in 1968-70 and 45 percent in 1973-74. At the end of 1974, the popular media were not filled with stories extolling the virtues of being a long term holder of stocks, and nobody was promising 30 percent annual returns.

This does not mean we are bearish, or even that we believe the markets necessarily face a period of sub-par returns. We do believe, however, that anyone claiming their investment performance is going to exceed the historical long term average bears the burden of explaining why this is the case.

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Once again we are faced with “new era” arguments to explain why the past is not a prologue. The most commonly advanced reason for expecting tremendous future stock market returns is retirement saving by aging baby boomers. It is a little hard to believe that something as widely reported as baby boomer demographics is not already “priced” into the market. Market prices tend to discount information that is known. Dramatic market movements tend to be the result of discovering the previously unknown.

It is not prudent to base long term investment expectations only on recent experience, much less the extravagant performance claims advanced by some investment managers. There is no compelling argument leading us to believe we are in a new era in which long term equity returns will exceed the 70 year average. Near the end of every extended bull market in the last 70 years, the “new era” arguments have been advanced, and they have always been wrong.

An old market saw is that “genius is a rising market.” There are now a lot of self-proclaimed geniuses. An investor with unrealistic expectations about portfolio returns is unlikely to be emotionally prepared to stay the course with a rational investment program when the bad times come, as they always do.

Data Source: Stocks, Bonds Bills and Inflation 1996 Yearbook, Ibbotson Associates