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Millennial Thoughts: Reversion or Conversion?

*O let not Time deceive you,
You cannot conquer Time...
And Time will have his fancy
To-morrow or today*

As the end of the millenium approaches, a curious blend of optimism and pessimism suffuses what we read and hear. Y2K fears nag at us, with an inchoate fear of the breakdown of social order. After all, one of the attractions of our business is that it allows us to get away from the nitty-gritty of growing or killing our food. Investment pessimists view current markets as somehow being out of whack, with speculators driving stock values to the point where they are unhinged from the realities of the underlying businesses. At the same time, Internet-driven optimism is prevalent, with many believing that, to quote Dr. Pangloss, "all is for the best in the best of possible worlds." How should we reconcile these emotions?

***"The inseparable propriety of time,
which is ever more and more to
disclose truth" -- Francis Bacon***

Let's start by defining the issues. Rather than undergoing a conversion to the "new paradigm" school, pessimists believe there is a long-term fundamental rate of return generated by stocks, with a "reversion to the mean" in which good periods are offset by bad periods and vice-versa, fluctuating around a fairly consistent long-term average. Optimists believe each period is on its own, unaffected by previous periods.

Intrigued by these different views of the investment world, we decided to investigate if there was even a mean, or long-term average return, to revert to. How stable have been the long run returns on stocks? Since 1802, before the Louisiana Purchase, the real (adjusted for inflation) average annual return on U.S. stocks through 1998 has been 6.42 percent -- not exactly a rate to make the heart beat faster in our current bull market.

From 1802 to 1900, the average annual real return was 6.19 percent. This century, from 1901 through 1998, the average return was 6.64 percent, better, but hardly grist for those who believe everything is constantly improving. After 197 years, neither 19th nor 20th century returns varied from the long-term average by as much as a quarter of one percent.

This is not to say that there haven't been significant fluctuations around the average. This century saw a 58 percent decline in U.S. stocks in real terms in 1928-32 and a 51 percent decline in 1972-74. If you were counting on reverting to the mean, you might have gotten a little impatient in the mid-1970s, when for

the prior 46 years you would have averaged real returns only a little above 4 percent per year. We reverted to the long-term mean by enjoying an 11.58 percent real average annual return from 1975 through 1998.

***"Times go by turns, and chances
change by course, From foul to
fair, from better hap to worse"
-- Robert Southwell***

We looked overseas for further evidence. Unfortunately, in this century, foreign markets have had the nasty habit of shutting down or becoming worthless as a result of revolution, war, hyperinflation and the like. Common stocks in Great Britain, however, had an average annual real return from 1802 to 1998 of 4.91 percent. Neither the 19th nor the 20th century returns vary from this long run average by as much as a fifth of one percent. If we extend the British data 298 years back to 1701, the average annual real return was 4.70 percent. In none of the three centuries included were the average annual returns different from the long run average by as much as half of one percent.

There have been a lot of new eras in the past 200 or 300 years, with marvelous advances in technology, from railroads and canals to electricity to the automobile to computers to the Internet. The evidence, however, supports the idea of a long run common stock return that may surprise investors who have only experienced one of the upside waves above the average. In other words, history favors reversion over conversion. (Those of you believing in efficient capital markets can explain to us sometime the persistence of a 200-year arbitrage opportunity between the U.S. and England.)

As with previous year-end letters, readers who correctly identify the authors of the opening and closing quotations will win a modest prize. If your millennial to-do list includes reviewing your investment program, contact us.

*Time present and time past
Are both perhaps present in time future,
And time future contained in time past...
Only through time time is conquered*

Data source on real returns: Global Financial Data. (www.globalfindata.com, (818) 284-0341).