

US Equities' Heartbreaking Performance is Nothing New

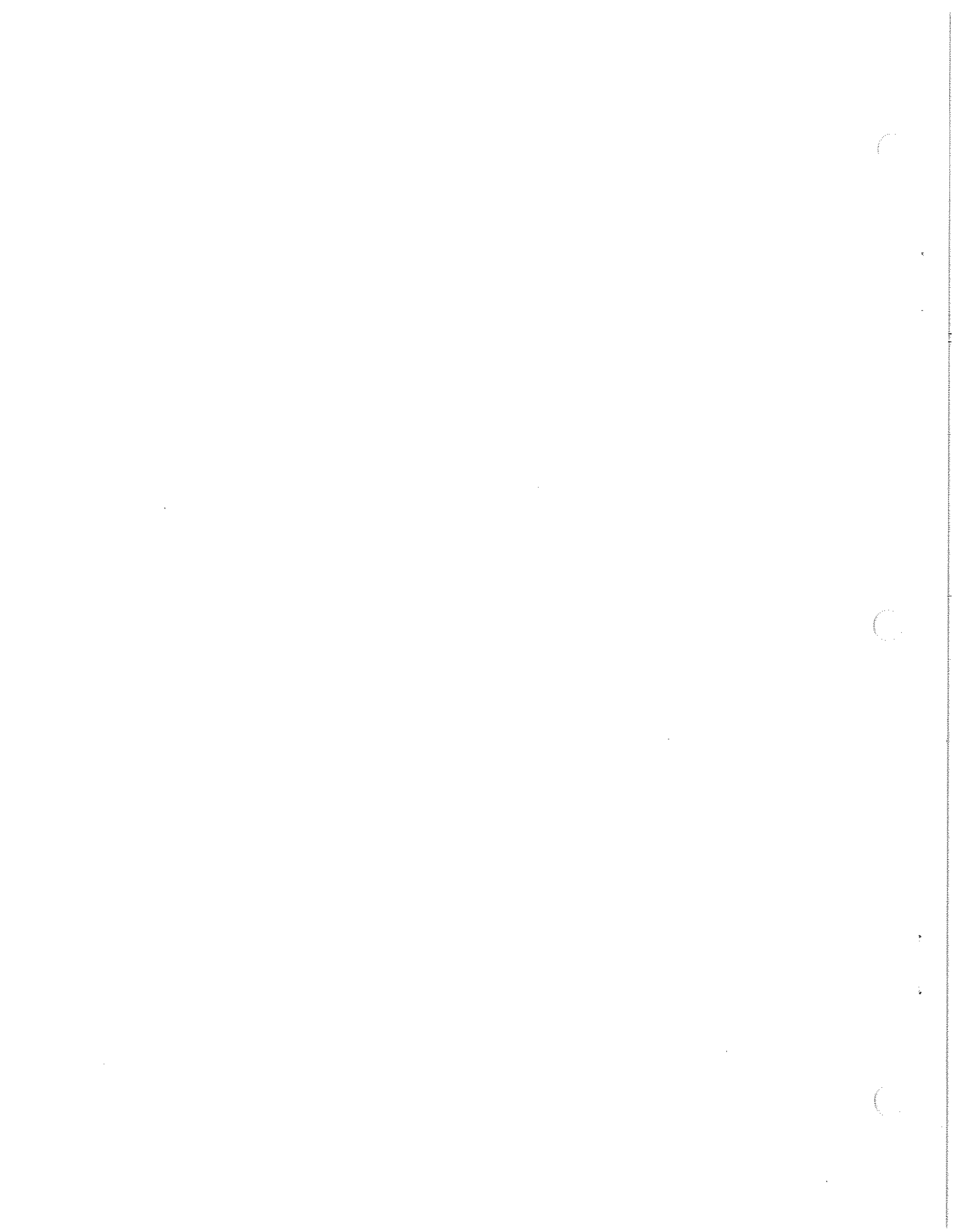
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Abstract

US equities have delivered devastatingly poor long-term returns with surprising regularity: in the 1910s, the 1930s, the 1970s, and the 2000s. Following the bear markets of the 1930s and the 1970s, stock valuations languished for a considerable period before providing investors with long-term returns that outperformed inflation. Investors should consider that much of the increase in stock values from March-August 2009 may be driven more by a 1990s-style belief in the infallibility of equities as an investment class than by tangible improvements in global economic conditions. The risk remains that much of the gains in stocks in 2009 could be another "false start" that characterized recoveries from former "super-bear" markets.

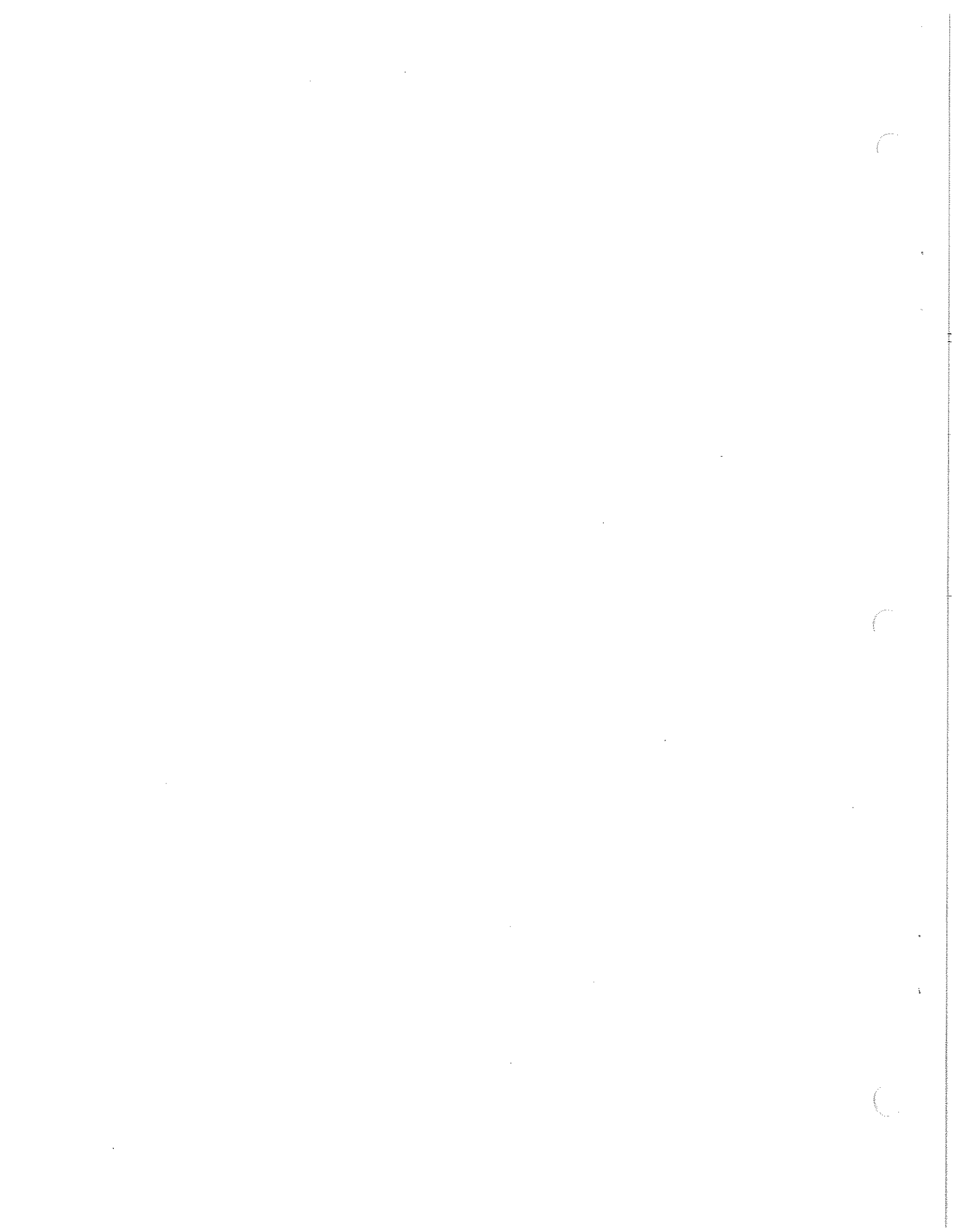
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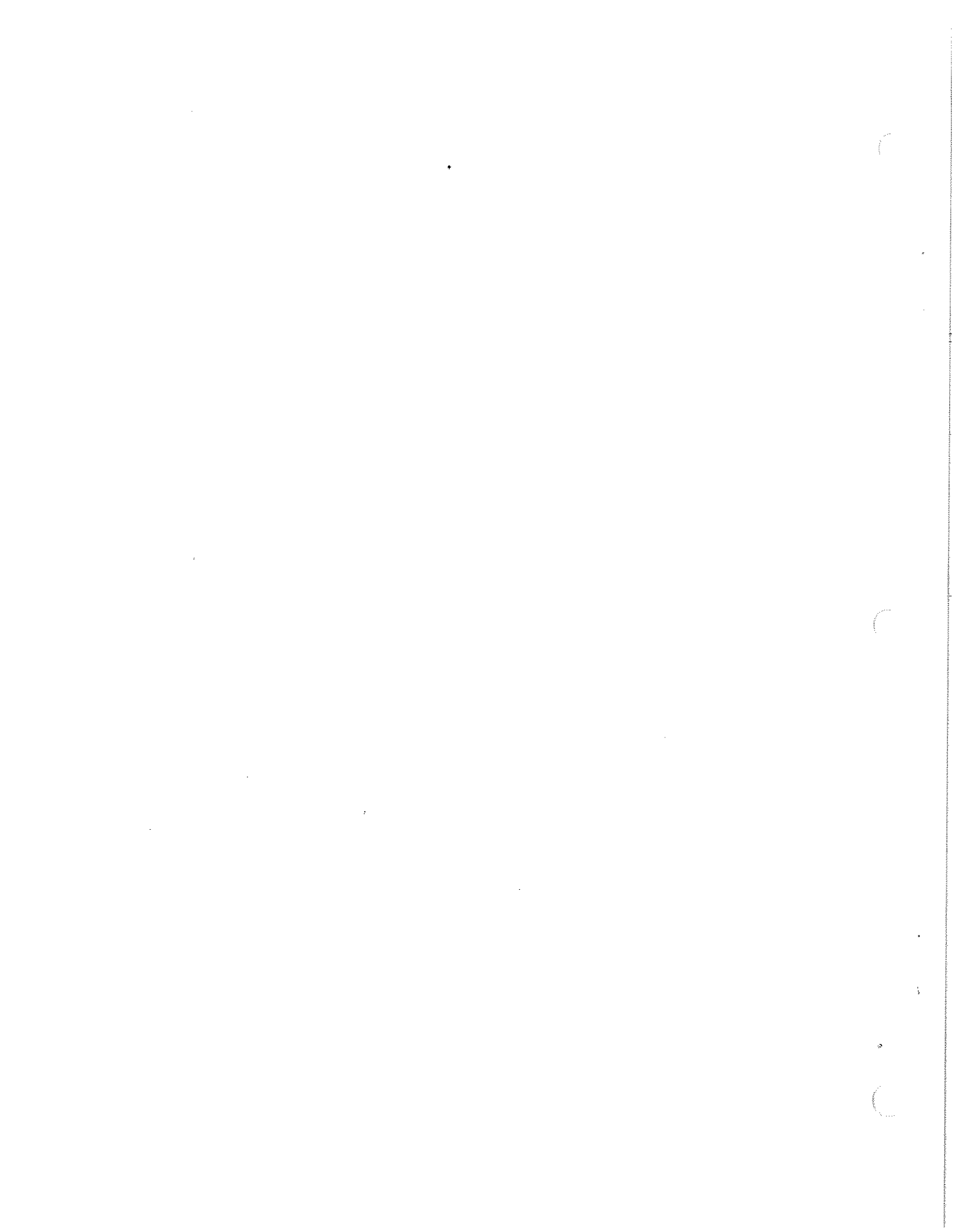
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Introduction

One of the most puzzling aspects of the 2008-09 bear market is investors' sense of denial regarding the profound decline in equity values. I have repeatedly encountered a deep-seated unwillingness to believe that equities can lose 50% of their value in a matter of months. In my conversations with investment advisors, individual investors and endowment and pension officers, the question "how could this have happened?" arises routinely.

This paper demonstrates that a straightforward answer to this question exists: stock valuations exhibit prolonged declines every few decades with almost predictable regularity. The long-term performance of equities thus far in the 21st century is not materially different than it was during select periods from the previous century — what is different is investors' willingness to believe that their portfolios can be devastated by these "super-bear" markets from time to time.

1. The Culture of Equities

Figure 1 depicts the annualized real 10-year return (dividends reinvested) that a buy-and-hold investor in US equities would have earned from each starting date on the *x*-axis (data courtesy of Shiller, 2009). For example, someone who bought at the peak in 1929 and reinvested all dividends would have underperformed inflation by about -3% per year for the next decade. Conversely, an investor who bought at the market bottom in 1982 would have outperformed inflation by about +13% per year for the next 10 years. Much of investors' current angst is probably due to the fact that buying and holding US equities from the 1999-2000 stock market peak yielded inflation-adjusted returns of approximately -6% per year — thus the increasing popularity of the phrase "the lost decade."

{Insert Figure 1 Here}

The chart makes it clear that investors in past decades have also experienced prolonged negative real returns, however. It is my impression that some of investors' disbelief regarding the carnage visited upon their portfolios — and some of what has driven the increase in US equity valuations from March-August 2009 — is that stocks' disappointing long-term performance is impossible to reconcile with the "culture of equities" propaganda that was perpetrated on the investing public throughout the 1990s and early 2000s.

Jeremy Siegel's bestselling book *Stocks for the Long Run* promoted the viewpoint that equities were less risky than bonds over long holding periods (20 years or more). With the benefit of hindsight we now realize that the research Siegel conducted for the book was completed when stocks were consistently beating inflation by more than 10% per year. It is fair to assume that equities' amazing performance over this period exerted a considerable influence on Siegel's views — and his unwaveringly bullish stance did not hurt his money management aspirations, either. Publication of Glassman and Hasset's *Dow 36,000* further reinforced Siegel's thesis. Glassman and Hasset exhorted readers to believe that equity premiums had been too large historically and that stock values should be much higher. (As of the market bottom of March 2009 these authors were only off by 30,000 Dow points, give or take a few).

Even US Federal Reserve Chairman Ben Bernanke (2004) perceived that the world was entering a period he called "The Great Moderation," a phrase he coined just before the wheels began to come off the global economy and financial markets. If experts such as these can get it so wrong — Siegel is an esteemed Wharton professor, Glassman is a senior economist with J.P. Morgan, and Bernanke is the Chairman of the US Federal Reserve Bank — individuals should not blame themselves for also getting it wrong. One key point of this essay, however, is that in the future, investors would be well served by remembering that during periods of euphoric equity

valuations that presage unsustainable market tops, popular cultures' alleged "experts" tend to provide deeply misguided advice, and do so with surprising consistency. Of course, this perspective may also apply to the advice currently being dispensed regarding the apparent robustness of the recovery in US stocks from March-August 2009.

2. Lessons From the Past and Implications for Current Investors

Figure 2 re-presents the long-term returns from Figure 1 with 36 month smoothing to emphasize the longer-term trends. A few noteworthy items stand out.

{Insert Figure 2 Here}

First, stocks' long-term real returns can be below average — and below zero — for extended periods — *especially when recovering from the most severe bear markets*. Buy-and-hold equity positions established during the 1910s, 1930s, 1970s, and 2000s earned low and sometimes negative real returns that persisted for a decade or longer. Investors should therefore not be highly surprised by the dreadfully low returns of 2008-09, as markets have repeatedly delivered similar returns throughout the history of investing. What I find more surprising is the fact that, collectively, investors sometimes become especially eager to ignore history and embrace the overly optimistic messages of people like Siegel, Glassman and Bernanke. Investors who instead followed the more prosaic John Bogle (2007) equity allocation formula (100 minus one's age) may have still lost substantial wealth in the recent bear market, but not nearly as much as a culture-of-equities asset allocator likely to be 100% invested in equities at all times. Bogle's advice may be less exciting, but also far less hazardous to investors' wealth.

Second, examination of Figure 2 suggests that market-timers need to be highly skilled. If market timers cannot identify a market bottom within a few months, they will miss out on the best of the outsized real returns. Timers may still perform a few percentage points above

average, and possibly avoid the bottoms of bear markets, but to do this repeatedly requires that one lives to be at least 150 years old. Market timers and frequent traders are also condemned to spend far more time monitoring their investments than investors who follow Bogle's (2007) simpler recommendations for building wealth.

Third, after "super-bear" market tsunamis, returns can languish for long periods. As a matter of fact, the only V-shaped long-term stock market recovery following a super-bear began in the 1910s. The bear markets of the Great Depression and the 1970s were followed by long, drawn-out periods of lackluster returns. The implication is that the current global economy would require a "perfect storm" type of recovery in corporate and residential real estate, credit markets, consumer spending and corporate earnings for the bull market of 2009 to establish itself on an economically solid foundation in the short term. While it is not impossible for this to happen, the history of stocks' recovery following past super-bear market declines suggests that these types of prompt rebounds have occurred only rarely in the past.

3. Conclusions

Throughout the history of investing, US equities have delivered devastatingly poor long-term returns with surprising regularity: in the 1910s, the 1930s, the 1970s, and the 2000s. Following the bear markets of the 1930s and the 1970s, stock valuations languished for a considerable period before providing investors with long-term returns that outperformed inflation. Investors should consider that much of the increase in stock values from March-August 2009 may be driven more by a 1990s-style belief in the infallibility of equities as an investment class than by tangible improvements in global economic conditions. The risk remains that much of the gains in stocks in 2009 could be another "false start" that characterized recoveries from former "super-bear" markets.

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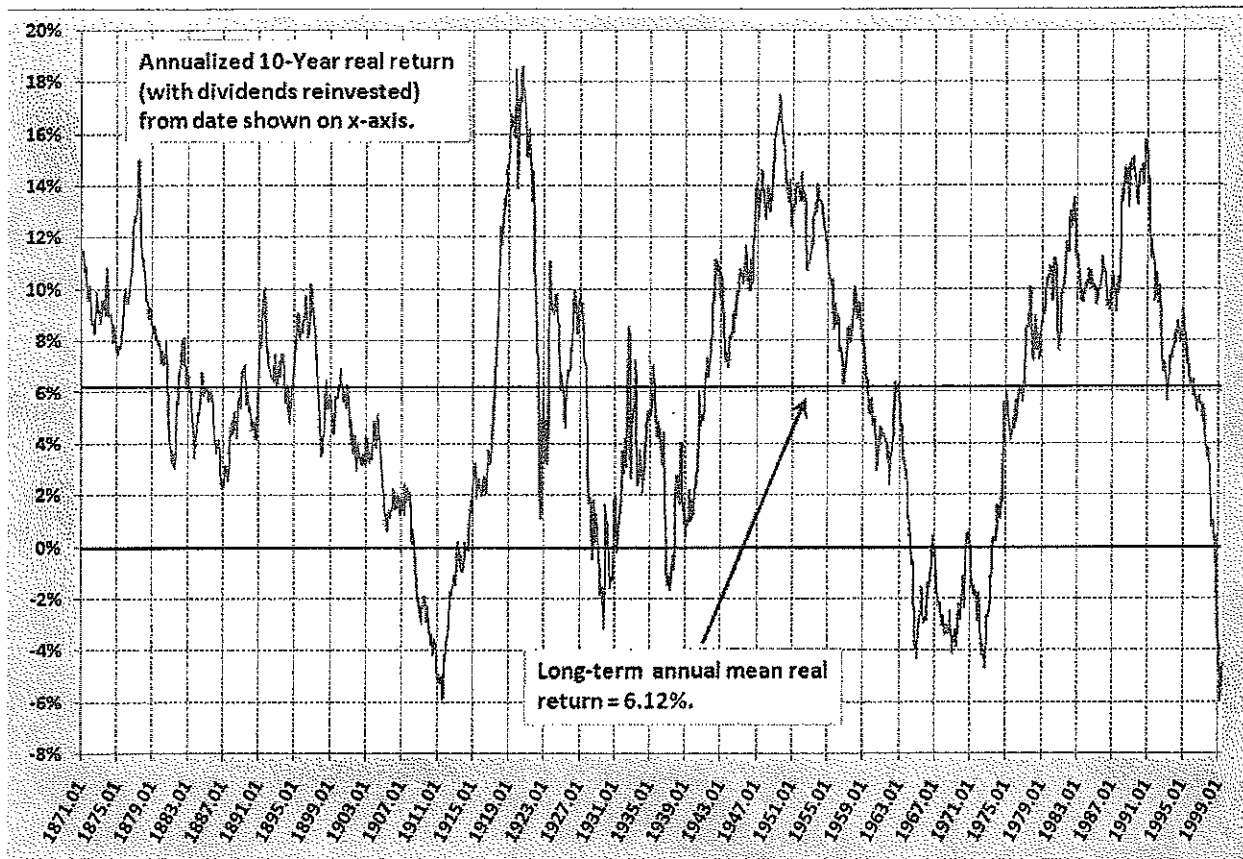


Figure 1. Annualized 10-year real returns from 1871-1999.

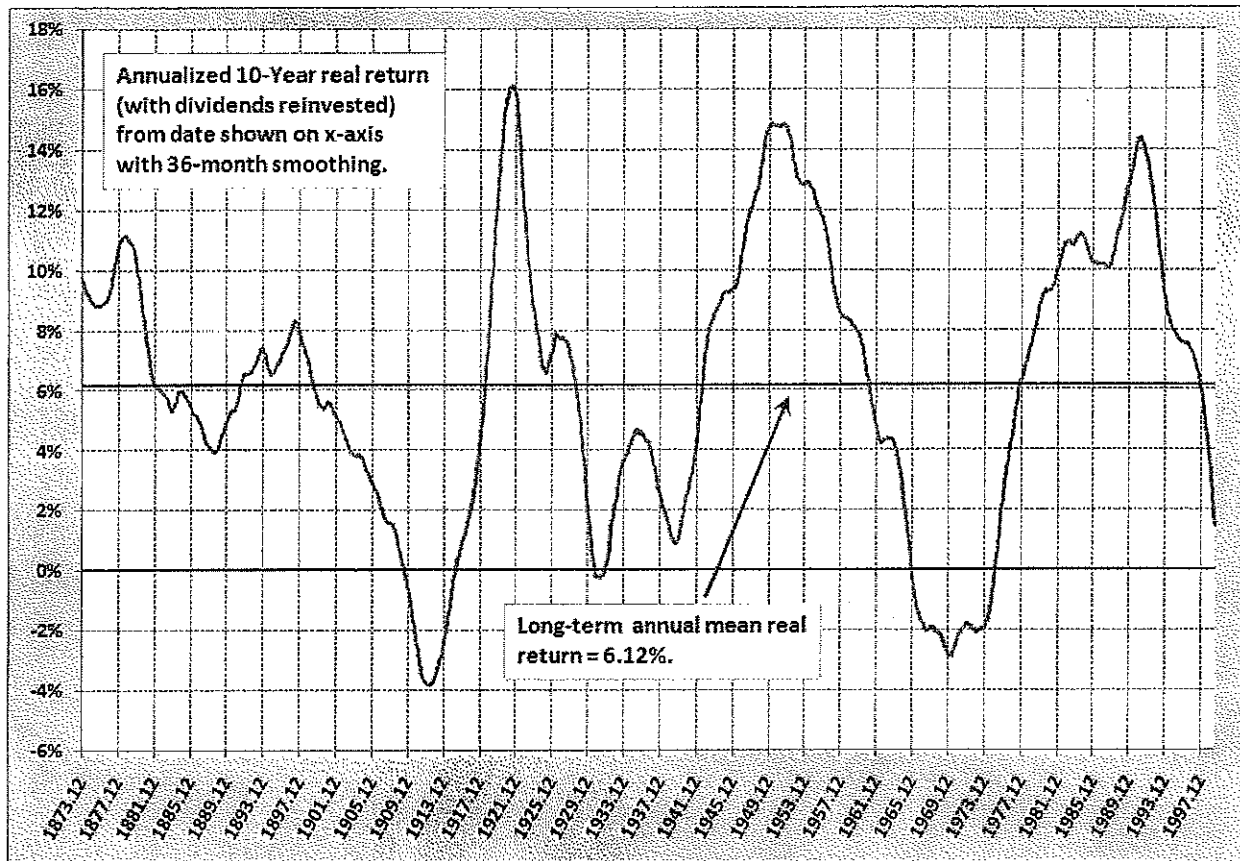


Figure 2. Annualized 10-year real returns from 1871-1999 with 36-month smoothing.