Boomers Beware: Why Today's Investor Will Never Get the Stock Market's "Average" Return

by Arthur J. Minton, Ph.D.
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Many investors base their investment decisions on the assumption that the stock market will, over their lifetime, deliver an "average" return of 10 -12%. This is what Wall Street propagandists tell us is the "average" return, and, in fact, since 1926 (the starting date for this estimate) it has been. What is not mentioned, however, is that over this eight-decade period, there have been long stretches of time when the market delivered nominal returns of less than 5% and real, inflation adjusted returns of 0%. An eight-decade average is just that – an average – with periods above and below the norm. What an investor gets depends on the starting point, and today's investor is starting at one of the most unfavorable moments in history.

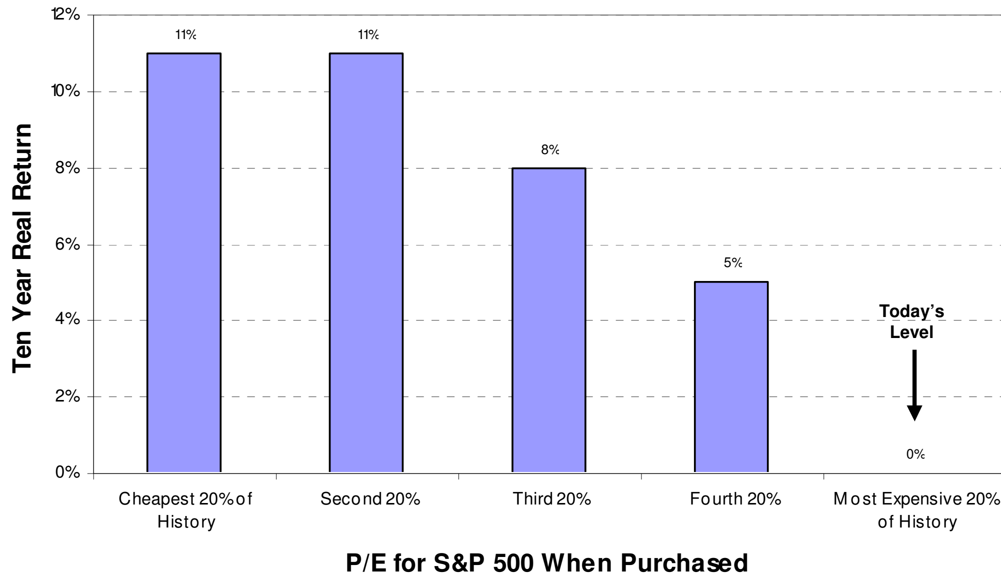
The stock market goes through two basic bull and bear market cycles. A normal cycle lasts 4 – 5 years from low point to low point and tends to correspond to the Presidential Election Cycle. Low points in the market tend to occur in year two of the presidential term (1970, 1974, 1978, 1982, 1990, 1994, 1998, 2002) and the most robust returns tend to occur in years three and four. These short cycles occur within a larger framework of valuation, from cheap to expensive and back to cheap again. Valuations are measured by Price to Earnings Ratios (P/E). This valuation cycle can last from 15 – 20 years, averaging about 17 years.

From the early 1980's to 2000, investors enjoyed one of the biggest positive valuation cycles in history. Stocks began cheap (under 10 times earnings) and ended up very expensive (over 30 times earnings). The combination of rising earnings and expanding valuations of those earnings produced long-term returns averaging about 15% annually (see attached chart). It was a golden age of stock market investing.

Alpha believes that a new valuation cycle began in 2000, and that we are now moving from high valuations to low valuations over a long period of time. The S&P 500 in 2000 was priced at 32 times earnings, a historic record. Today, in 2008, the S&P 500 has not surpassed its 2000 high point, and sells at about 20 times trailing five year earnings. This level of valuation is still one of the highest in history, comparable to highs in 1965, the start of a long negative valuation cycle which lasted until 1982.

Quintiles of Market Average P/E to Predict 10-Year Returns

20% of the Time, Stocks Return 0% Real Over 10 Years



Because today's market falls into the most expensive quintile of valuation historically, investors should expect that high total returns will be hard to come by for many years. Passive strategies, such as indexing and index-style active management, which performed superbly from the mid-80's to 2000, will produce low, below-median returns for the foreseeable future.

This trend does not bode well for retirees who are expecting the stock market to compound at 10 -12% annually in order for them to retire at income levels which provide a lifestyle comparable to their pre-retirement years. Real (inflation adjusted) returns of between 0% and 4% are more likely, based on historical returns from today's valuations.

Further complicating this trend is the good news that life expectancy is increasing dramatically. The Boomer Generation may possibly live another five to ten years longer than current actuarial tables forecast. The bad news is that many have not saved enough for an extended life span, let along 30 years of retirement.

Let's imagine that you have saved and invested and now you want to retire. Your nest egg is now worth $1 million. You decide to take out 5% of your total portfolio to live each year and increase the amount for inflation, so that you can maintain your standard of living. You are told that the stock market delivers the highest return over time (which it does) so you are invested 100% in stocks. This sounds like a pretty conservative plan, doesn't it?

In fact, this plan has significant risk because we know that the returns you get over the next 30 years are highly dependent on the P/E ratio at the beginning of those 30 years. There have been 78 thirty-year periods since 1900. Let's separate those periods into four quartiles of beginning valuation. If you start in a period when P/E ratios are in the highest quartile, you find that over 50% of the time you end up penniless, on average, in 22 years, assuming a 5% withdrawal rate.

QUARTILES	STARTING P/E RANGE	SUCCESS RATE	AVERAGE ENDING $s	AVG YRS IF OUT OF $s
Top 25%	18.5 +	47%	$ (850,676)	21.8
Second 25%	13.9 to 18.4	70%	$ 1,607,294	21.5
Third 25%	11.2 to 13.8	80%	$ 6,326,247	26.5
Bottom 25%	below 11.2	95%	$ 7,661,859	30.0
ALL PERIODS	14.6 avg.	73%	$ 3,693,376	23.0

Because valuations are now in the top quartile, expecting "normal" or "average" returns over the next 20 – 30 years makes no sense. Even if the market were to fall to the third quartile, there is still a 20% probability that a diversified portfolio of stocks would be depleted in 26.5 years.

Obviously, as a portfolio shrinks, the natural tendency is to reduce the income stream more and more, thereby reducing one's standard of living in the face of a fairly constant inflation rate. The other option is to keep withdrawing no matter what and pray for a miracle. It's a double whammy no one wants to face.

What to do then?

Even in long bear markets there are periods of investment opportunity. Markets are volatile, and while the long-term pattern of the market may be sideways, this will be punctuated by significant declines and advances that can be exploited. To exploit them calls for a policy of active asset allocation; in particular, a strategy that lessens the effects of periodic bear markets. This type of strategy is Alpha's specialty.

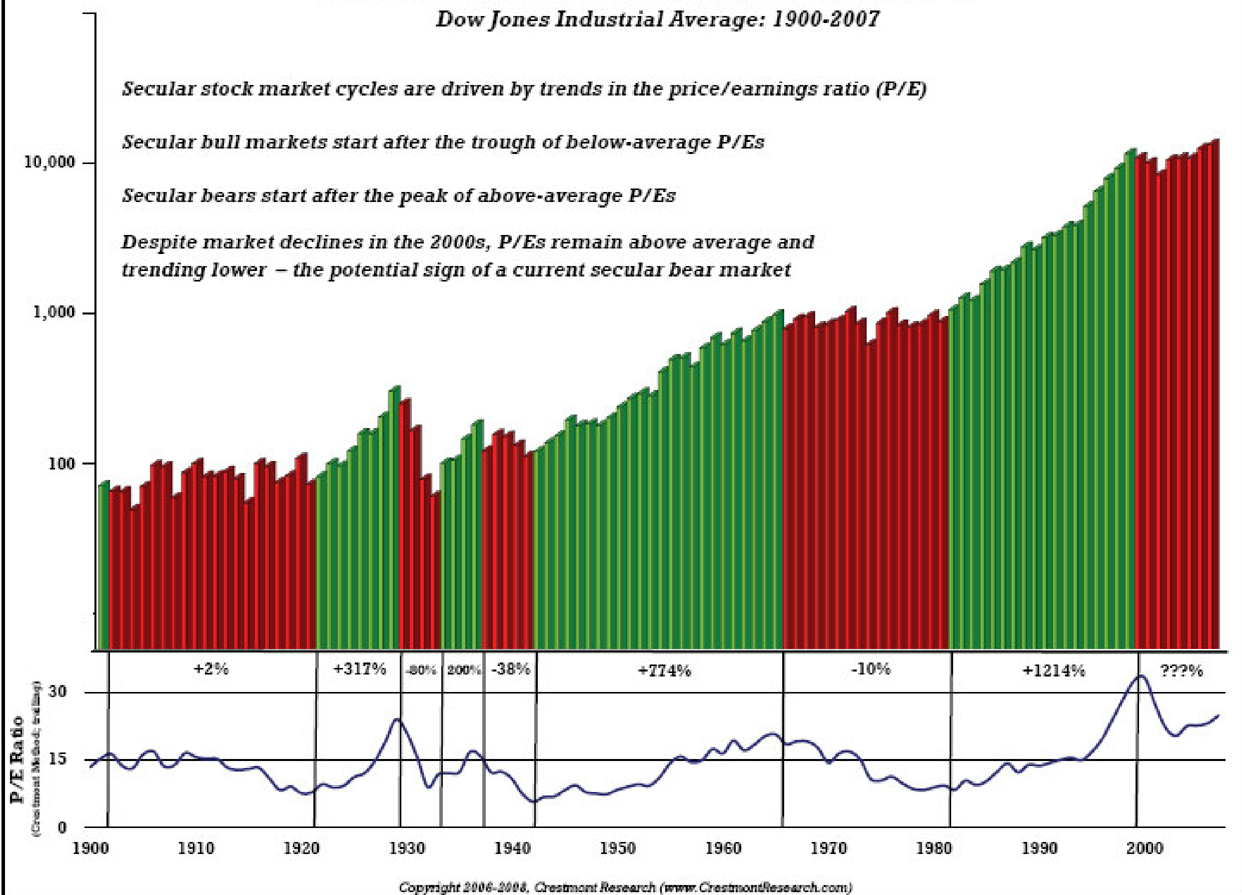
In addition, there are new investment vehicles which offer a substantial set of growth and income guarantees that effectively eliminate the risk of declining income during the lifetime of the investor and his/her spouse. These vehicles are now offered by major annuity companies and come with a "guaranteed lifetime withdrawal benefit" which insures a constant income stream that cannot be outlived.

It is possible, using these vehicles, to eliminate "portfolio risk" to the income formula. Most of these vehicles use a 5% withdrawal rate as the maximum, but factor in a continuously rising benchmark if the underlying portfolio of mutual funds is doing well. This feature allows for a steadily rising stream of income for life under favorable market conditions, with no risk to that income stream should markets collapse and the underlying portfolio decline substantially in value.

Using these vehicles, an investor can keep control of the investment portfolio within certain guidelines, employ active asset allocation in a tax-deferred account, guarantee a worse-case scenario that insures a lifetime income, and pass on the value of the portfolio to the estate at the death of the surviving spouse.

Alpha Investment Management can help you explore this possibility and other "alternative" strategies.

Data courtesy of Crestmont Research (www.CrestmontResearch.com)


SECULAR STOCK MARKETS EXPLAINED
Dow Jones Industrial Average: 1900-2007
Secular stock market cycles are driven by trends in the price/earnings ratio (P/E)
Secular bull markets start after the trough of below-average P/Es
Secular bears start after the peak of above-average P/Es
Despite market declines in the 2000s, P/Es remain above average and trending lower – the potential sign of a current secular bear market
10,000
1,000
100
+2%
+317%
-80%
200%
-38%
+774%
-10%
+1214%
???%
P/E Ratio
30
15
0
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
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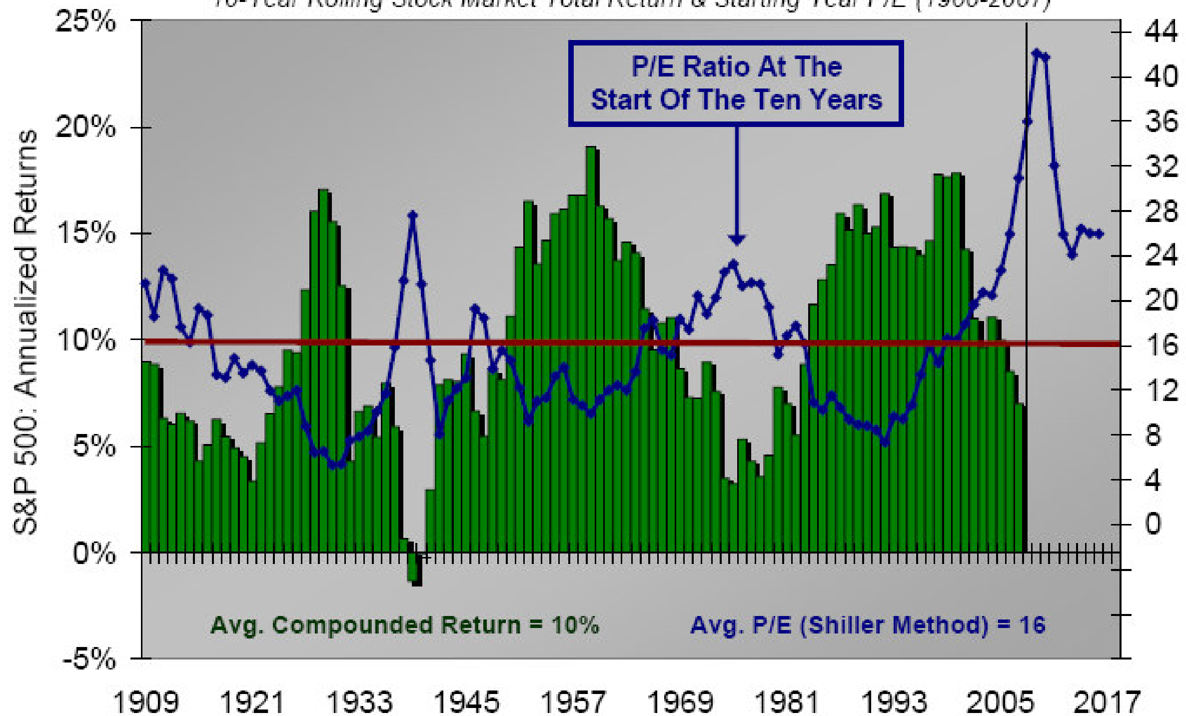
GAZING AT THE FUTURE:
WHY STOCKS WILL UNDERPERFORM
10-Year Rolling Stock Market Total Return & Starting Year P/E (1900-2007)
P/E Ratio At The Start Of The Ten Years
S&P 500: Annualized Returns
25%
20%
15%
10%
5%
0%
-5%
44
40
36
32
28
24
20
16
12
8
4
0
Avg. Compounded Return = 10%
Avg. P/E (Shiller Method) = 16
1909
1921
1933
1945
1957
1969
1981
1993
2005
2017
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