Capital Markets Brief

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Extraordinary Stock Returns & The Dangers of Flawed Extrapolations

Despite back-to-back negative results during 2000 and 2001, the US stock market has generated extraordinary cumulative and average returns over the last two decades. However, all the media coverage that projects recoveries in the shape of Us, Vs or Ws to the contrary, investors should not expect stocks to return to the growth levels of the 1980s and 1990s. To assume that the '80s and '90s represent a ***normal pattern*** for stock returns, and to use that pattern to extrapolate future returns, supposes that current stock market valuations — which quadrupled over that period (relative to underlying earnings and dividend growth) — will repeat that growth spurt. History and common sense tell us that this is highly unlikely. Those who fall into this error will be extrapolating from a flawed assumption.

In past articles I have promoted the virtues of fundamental analysis, specifically valuation. Those that formed their assumptions about the future based on an extrapolation like the one above are already feeling the pressure of such an ill-advised approach. Several large pension funds are currently faced with large unfunded pension liabilities because they gave in to the temptation to extrapolate from the recent past as though it were an "average" market environment. This is not only bad for the beneficiaries, but also for the shareholders (when pension expenses show up on the balance sheet). These investment professionals should have known better — just because stocks posted annual returns of 10% to 12% over the last 75 years does not mean they will do so over the next 75, 50, 20 or 10 years!

What really drives future performance is earnings growth, dividend growth and change in valuation. Clearly, we are in a period when dividend yields are at the low end of their historical distribution range and price-to-earnings multiples are at the high end of the range. Earnings growth, the third "driver", is difficult to forecast for individual companies, but in aggregate, it tends to correlate very closely with real per capita GDP. Estimates of earnings growth that range from 12% to 15% a year are ignoring this fact of economic life, and are also flawed.

There is no logical basis for an expectation that stocks will deliver returns more than 7% above Treasury bonds (the historical equity premium). The true equity risk premium (expected return of stocks less expected return of risk-free asset) based on today's valuation levels is about 3%, far lower than the returns that most investors have come to expect.

Extremes in market valuation (over/under) have been, and will most likely continue to be, the primary force behind stock market returns. Based on this premise, different sectors of the US stock market should produce disparate results, near-term. For instance, there are large differences in valuation levels between value and growth and large- and small-cap stocks. Lockwood's new investment strategy portfolios (strategic asset allocation models) reflect this dislocation.

Although the overall stock market is expected to underperform its long-term historical average for the foreseeable future, we still expect stock returns to be higher than bond returns after inflation. Value stocks, small/mid-cap stocks and a diversified portfolio of international stocks from developed markets should provide investors with slight return premiums over the overall stock market.

Successful investing requires patience, a well balanced approach and reasonable expectations. Never has this been a more relevant formula than in the current environment.

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