

## Waiting For Average

### ***Why The Long-Term Average Will Never Occur For Today's Investors***

(Updated June 2008)

The long-term average return from the stock market is 10.4%. As the earliest baby boomers are now beginning to retire, they will be relying upon their investments for income. The latest boomers have two more decades to compound their savings into a retirement payload. At 10%, boomers young and old—so to speak—have a good chance of a secure retirement. Yet, from 2008, what length of time is needed to assure the long-term average return?

NEVER—investors from today will never achieve the long-term average return. Not in ten years, twenty years, fifty years, or the seventy-nine years that represent the most recognized long-term average return.

According to the *2008 Ibbotson Classic Yearbook* published by Morningstar, Inc., the long-term average return from the stock market is 10.4% (pg. 31). Ibbotson starts their long-term series of financial data in 1926 (pgs. 30, 201). Eight decades is a long, seemingly credible period of time—why shouldn't today's investors reasonably expect a similar return over the next one, two, or eight decades?

There are only three components to stock market returns: earnings growth, valuation-level changes (i.e. the change in the P/E ratio), and dividend yields. A discussion of these three components will confirm that a reasonable future return assumption is less than two-thirds of the long-term average.

Before we look forward, let's look backwards for insights. Let's use the certainty of history to explain the contribution of each of the components to the long-term average of 10.4%. According to Ibbotson, earnings growth contributed 5.2% to the long-term average (pgs. 177-179). Since P/E ratios

were 10.2 in 1926, the effect of the increase to 19.8 at the end of 2007 provided 0.8% to the long-term average (pg. 177). Finally, partially related to the starting and average P/E ratios, the dividend yield averaged 4.4% over Ibbotson's period of choice (pg. 178). Combined together, the compounded total return (before transaction costs, fees, expenses, etc.) averaged 10.4%.

So looking forward, from conditions that exist at the starting point of 2008, what are reasonable assumptions for the three factors over the next few decades? To assist in the discussion, concepts and data from the book *Unexpected Returns: Understanding Secular Stock Market Cycles* will be referenced.

First and foremost, we can eliminate the impact of significantly higher P/Es—the level of valuation cannot be reasonably expected to double to 40 over the next eight-two years. Given that we are near historical highs for the P/E ratio (excluding the two bubbles during the past century), any further material increase in P/Es is unrealistic. Past bull markets peaked with P/Es in the low to mid 20s; there are financial reasons, explained in *Unexpected Returns* (pg. 155-161), that P/E ratios cannot be sustained above the mid-20s. Therefore, if P/Es can at least be maintained at currently high levels, the best-case long-term return is 9.6%, the long-term average of 10.4% less the 0.8% impact of P/E expansion.

The second component, earnings growth, is closely tied to economic growth. Over the past decades and century, as discussed in chapter 7 of *Unexpected Returns*, earnings growth is closely related to Gross Domestic Product ("GDP"). GDP growth is comprised of real growth in GDP plus inflation. Today, inflation is being tightly controlled by the

Federal Reserve Bank and is running below the historical average. As a result, future nominal earnings would be expected to grow at a slower rate than the historical past. Although it may not be much of a change, a 1% slower nominal growth rate shaves almost another 1% off of the potential return provided by earnings growth. Please keep in mind that if inflation does increase, the resulting decline in P/E ratios will more than offset the benefit to earnings growth. So with the more optimistic low-inflation scenario, we're down to a best-case long-term return of 8.6%.

The final component, dividend yield, is directly and mathematically related to the starting level of valuation—the P/E ratio (*Unexpected Returns*, pg. 103-105). In 1926, when the P/E ratio was close to 10, the dividend yield was approximately 5%. At the current P/E of 20, the normalized dividend yield drops to less than 2.5%. The dividend policy and payout rates for companies do not change as the result of the level of its P/E ratio. A company that generates \$2 per share will typically pay out a little less than \$1 per share in dividends regardless of whether its stock price is \$20 or \$40 (i.e. 10x P/E or 20x P/E). Yet the dividend yield when the P/E is 10 will be 5% (\$1 dividend on a \$20 price), while the dividend yield at a P/E of 20 will be 2.5% (\$2 dividend on a \$40 price). The effect of today's valuation levels, P/E near 20, reduces the expected yield by more than 2% versus the historical dividend yield. As a result, our best-case future long-term return approaches 6%.

Of our three components in the future, two of them—earnings growth and dividend yield—are good soldiers that will provide a fairly predictable contribution to total return near 6%. The third component—changes in the P/E ratio—will determine whether realized returns are near 6% or are much less. The trend in P/E ratios significantly impacts multi-year returns. During periods when the P/E increases, earnings growth is multiplied;

whereas, periods of P/E declines mitigate EPS growth. The result is periods known as secular stock market cycles. From currently high levels, any decline in P/Es will reduce long-term returns below 6%. The magnitude of the shortfall will depend upon whether the decline stops at the historically average level or further declines to typical secular market lows.

The discussion of the components for future returns is complete—all three parts indicate below average returns in the future. Earnings growth will be lower than average, unless inflation increases. Dividend yields will be well below average as a result of current valuation levels. P/Es cannot contribute their past benefits due to their currently high levels. Finally, a decrease in P/Es, due to higher inflation or other factors, would offset the resulting modest gains in earnings growth. In the aggregate, investors can expect that the long-term return, based upon 2008 as the starting point, will be less than two-thirds of the historical average. Once P/Es retreat to average levels, future long-term returns from that point will increase. From now to then, investors would suffer the effects of a P/E decline. And only when the starting point for P/Es is again at 10.2 can investors expect that the historical long-term average return will again be possible.

As a result of the current environment and conditions, investors have two alternatives: reasonable expectations or blind hope. Unfortunately for the boomers, historically average returns are not in the cards.

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