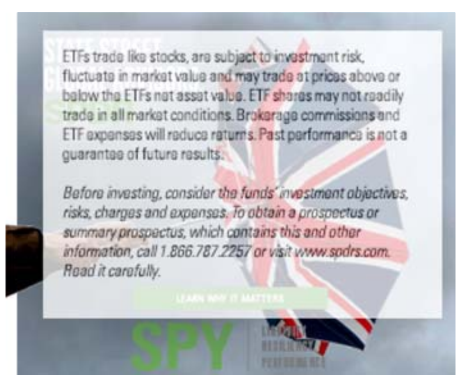
# [redacted] did in the 19th and 20th?




By **Mark Hulbert**
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*Whether you think the market will return 3% or 7% annually should dictate how you invest*

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CHAPEL HILL, N.C. (MarketWatch) — Will the stock market in coming years behave like it did during the last two decades — or the two centuries before them?

It's impossible to know, but it's crucial to review the evidence on both sides. A lot is riding on which past you bet will be prologue.

If the stock market lives up to its average over the 19th and 20th centuries, it will produce a return above inflation of around 7% annualized, according to Jeremy Siegel, a finance professor at the Wharton School and author of Stocks for the Long Run. That would mean we can expect the purchasing power of our equity holdings to double every 10 years, on average.

So far this century, however, the market's return has been a lot lower than that. Since the March 2000 high, for example, the dividend-adjusted S&P 500 has produced only a 2.4% annualized return above inflation, according to calculations from Jill Mislinski of Advisor Perspectives. https://www.advisorperspectives.com/dshort/updates/2017/04/04/the-s-p-500-dow-and-nasdaq-since-their-2000-highs

If we extrapolate that into the future, it will take three times as long — 30 years instead of 10 — for the purchasing power of our equity holdings to double.

It's hard to overestimate the effect this difference would have on any financial plan. It easily translates into the difference between retiring comfortably and having to work for many years past the normal retirement age. To be sure, you're not helpless if you choose to build your financial plan around the lower expected return. But you will have to make some hard choices: You will need to lower your standard of retirement living, save more, or look beyond U.S. equities for investment ideas.

**The arguments for extrapolating the 19th and 20th centuries' average into the future**

Siegel offers what is perhaps the strongest and best-known argument in favor of extrapolating the 7% return into the future. Not only has he documented that stocks have produced a long-term average 7% annualized real return, he has found that this return has been remarkably consistent: Each 40+ year period since 1801 has experienced returns within shouting distance of the two-century average

Siegel's data also show that two-decade returns as low as 2.4% annualized have occurred before. So the mere fact that stocks have produced below-average returns since 2000 doesn't necessarily mean something fundamental has changed.

And on each occasion during which the stock market produced well-below-average two-decade returns, it came roaring back, producing well-above-average returns. In effect, a chart of stocks over the 19th and 20th centuries appears to show the 7% annualized trendline exerting a gravitational pull on equities — bringing below-average returns back up and pulling above-average returns down.

This translates into a rosy forecast for stocks in coming years, since the past two decades of subpar performance should be followed by above average returns.

**The arguments for why the stock market this century represents the "new normal"**

Skeptics have a number of responses to Siegel, many which boil down to the argument that there is nothing preordained about a 7% trendline. They point out that there are other ways of drawing a trendline, and relative to some, stocks currently appear to be overvalued — despite having produced below-average returns since 2000.

You could, for example, draw a trendline based on the S&P 500's price only, rather than adjusting it for dividends. Some consider this more appropriate, since dividends represent a much smaller proportion of equities' total return today than in past decades.

According to Advisor Perspectives' Jill Mislinksi, the market currently is 98% above a trendline based on the S&P 500's inflation-adjusted price back to 1871. She points out that there has been only one other period over the last 146 years in which the S&P 500 was further above this trendline than it is now: the top of the internet bubble in 2000.

Even if you adjust for dividends, however, you still get a different trendline than Siegel does if you pick a different starting year. When Mislinksi drew the same trendline as Siegel — based on stocks' inflation-adjusted and dividend-adjusted return — but started in 1871 instead of 1801, she found that the stock market currently is 6.1% above that alternate trendline.

**Financial planning implications**

What would it mean to financial planners if stocks' expected returns going forward were closer to 2.4% than 7% annualized? The answer would be easy — even though depressing — if we assume that every other asset class besides stocks would continue to live up to historical norms.

In that case, according to Chris Brightman, Chief Investment Officer of Research Affiliates, you would eliminate much if not all of your U.S. equity exposure, since Treasury bonds would have an expected return just as high as stocks with less volatility and risk.

Of course, as Brightman quickly added in an interview, given today's low interest rates it's as unrealistic to expect bonds to live up to their historical averages. So an investor allocating his portfolio between domestic stocks and bonds wouldn't necessarily need to change his asset allocation because of a reduced expected return for stocks.

What he would need to do, however, is dramatically lower the expected return of his retirement portfolio. Brightman forecasts that portfolios investing in domestic stocks and bonds will produce an inflation-adjusted return over the coming decade of around 3% — better than equities' 2.4% annualized return since 2000, but not much.

The implication for investors who focus only on domestic stocks and bonds, he said, is that they either need to reduce their expected standard of living in their retirement, invest more in their retirement portfolios, or both.

There is a third possibility, according to Campbell Harvey, a finance professor at Duke University's Fuqua School of Business: Invest in assets outside the U.S.

In an interview, he especially highlighted emerging market equities, in which most U.S. investors are significantly underinvested — a big oversight, he believes, and not just because nearly half of the combined global GDP is now produced by emerging economies, but also because emerging market equities are much cheaper than those in the U.S. and therefore hold out the prospect of significantly higher returns.

Brightman agrees, and adds that our search for higher expected equity returns doesn't necessarily involve investing in the stocks of some esoteric Third World outpost. He points out that the British stock market is far cheaper than the U.S. market right now — less than half as expensive, in fact, as judged by the so-called Shiller P/E.

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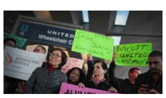

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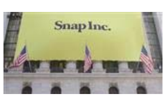


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*DATA PROVIDED BY* Bankrate

Mortgage Equity Savings Auto Credit Cards

| | |
|---|---|
| 5 yr CD | 1.3% |
| 2 yr CD | 0.78% |
| 1 yr CD | 0.61% |
| MMA $10K+ | 0.25% |
| MMA $50K+ | 0.39% |
| MMA Savings | 0.3% |
| MMA Savings Jumbo | 0.4% |

*National averages from Bankrate.com*

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Q. "Will stocks in the 21st century behave like they did in the 19th and 20th?"

A. No. Next question.

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Of course, if you start your analysis at the market peak before a big crash, future returns look bleak. Adjust your starting point a couple years forward or back and returns are normal. If you want to compare a decade of returns, do that. Don't go to a specific worst point that is 17 years ago. Go back 10 or 20 and you will see better results. While the past two decades have had significant bear markets, overall returns have been good, well above 2.4%.

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