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Investment Survival in a Single Digit World

By Richard A. Ferri, CFA

From January 1980 through September 2001, the stock and bond markets earned unprecedented gains. Despite the poor stock returns of late, the S&P 500 earned 14.6% annually over the 22 year period, and 5-year Treasury bonds returned a stunning 10.0%. Unfortunately, the era of double-digit returns has come to an end. Over the next ten years, we are likely to see significantly lower gains from the markets. Our ten-year forecast for the S&P 500 is 7.5%, plus or minus 2%, and the expected return for short-term Treasury bonds is below 4.0%.

Predicting the market is never easy and never accurate. There are too many variables and too much uncertainty. Nevertheless, we must try to calculate expected returns so that we have a guide to use when planning a portfolio. In this letter, the expected return of stocks is based on a simple earnings plus dividend model used by John Bogle, founder of the Vanguard Group. The return expectations of bonds are simply the current yields available in the marketplace today.

The key to stock market gains is corporate earnings growth. Historically, companies have produced earnings growth parallel to the growth of our economy as measured by the Gross Domestic Product (GDP). Our nominal GDP and earnings growth forecast for the next ten-years is 6%. By adding this number to the current 1.5% dividend yield of the S&P 500, we get an expected return on the stock market of 7.5% per year.

This gain does not include a speculative premium or discount, which is the price that investors are willing to pay for $1 of earnings as measured by the price-earnings ratio (P/E). Stocks are currently selling at 22 times earnings. A drop in the P/E to 18 times earnings would reduce the ten-year total return from stocks by two percentage points to 5.5%. If the P/E rises to 26, then the total return of the S&P 500 could reach 9.5%. There is no way to forecast how much confidence investors will have in the economy ten years from now, thus, you cannot forecast a final P/E. The table below shows two scenarios, one with a final P/E of 18 and another with a final P/E of 26.

Expected S&P 500 Returns

	1980-2001 Current PE=22	2002-2011 PE Contracts to 18	2002-2011 PE Expands to 26
Initial Dividend Yield	+5.7%	+1.5%	+1.5%
Earnings Growth	+6.3%	+6.0%	+6.0%
Investment Return	+12.0%	+7.5%	+7.5%
Speculative Return*	+2.6%	-2.0%	+2.0%
Expected S&P 500 Return	+14.6%	+5.5%	+9.5%
Initial P/E Ratio	9.2x	22.0x	22.0x
Final P/E Ratio	22.0x	18.0x	26.0x

* Impact of P/E Change

The expected return from the bond market is easier to forecast since interest rates are a direct reflection of the inflation rate. Intermediate term government bonds typically yield about 2% over inflation. In 1980, inflation was 13% and government bonds were yielding 15%. Today, inflation is around 2%, and 5-year government bonds are yielding slightly less than 4.0%.

Maturity of a Portfolio	U.S. Treasury High Quality	Expected Bond Market Returns	Corporate Municipal Bonds
Less than 1 year	2.0%	3.0%	2.0%
Short (1-3 years)	2.5%	3.5%	2.5%
Intermediate (4-6 years)	4.0%	5.0%	3.3%

There is good news in all of these low numbers. With any investment plan, inflation is your biggest enemy. While single digit returns for stocks and bonds is nothing to celebrate, we could earn real gains if the inflation rate remains low. The long-term forecast for inflation is 2.5%.

How to survive in a single digit world.

We hear many people talk about getting back into the stock market "when things get better". Our response to that line of thinking is "By the time things get better, the market is already up, which is not good for someone waiting to get in". The market pays you for taking risk. If you decide to wait, then you deserve no extra return when the economy turns around. Trying to time the ups and downs of the market does not work. No one has a crystal ball.

The best solution for handling single digit returns is to be well diversified. The percentage you should put in various stock and bond funds depends on your investment objectives and tolerance for risk. However, any allocation over 80% stocks or under 20% stocks does not work well. Portfolios with a very high concentration of stocks or a very low allocation are simply not efficient. The secret to survival is to pick a stock and bond mix that fits your needs and your personality. Then stick with that mix for many, many years.

We can hope for the return of double-digit gains, but we cannot afford to wait for them. We must continue to invest our money despite uncertainty. It is the only way we can build wealth to provide for our needs and the needs of our families.

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