What's the Long-term Return on Stocks?

In late November 2008 after the Lehman Brothers collapse and the market seemed in a free fall, I wrote a brief article questioning the conventional wisdom about the long-term rate of return on stocks as being 10% to 12%. On 11/26 the S&P stood at 843 and continued to sink to 666 on 3/3/2009.

Additionally, I hypothesized that as the economy and stock market attempted to recover that the actual fair valuation of the S&P as of 12/31/2010 might be about 1050, but that investors might have multiple opportunities to make 20% to 30% as the market traded in a range of 840 to 1300 as powerful economic forces alternately caused euphoria and panic over several years.

As the market closed today (1/27/2011) the S&P 500 stands at 1,299.54 (1300 rounded to the nearest whole number) up about 95% plus dividends since the 3/9/2009 low, essentially a double in less than two years. Is the market still headed higher as seems to be the consensus or is it headed for a major correction as a few contrarians proclaim? If you been in the market since the depths of 3/3/2009, should you take some money off the table or hang on and hope that it gopes still higher, perhaps recovering the 1,565 high on 10/9/2007? If you've bailed out of the market, do you get back in or wait for a correction (when of course it will seem to most to be a terrible time to invest)? How are you advising your clients?

I still don't have a crystal ball, but I think it may be wise to hedge our bets (with cash, options or principal protection, not bonds which may well be in their own bubble).

The long-term return for stocks is often cited as being in the 10% to 11% range. If you look at stocks by this measure, they're incredibly undervalued. Further the S&P is off over 50% since the 2000 peak. This 10% + return may well have been significantly overstated being skewed by abnormally high returns in the 80's and 90's.

However, I was just looking at a 38-year chart of the S&P which clearly highlights enormous bubbles against a much lower long term trend. The S&P in 1995 (before the sharp increase that led to the 2000 bubble busting) was about 425 compared to 100 in 1970. This was about a 6% return (with probably an additional 1 to 1.5% dividend yield – 7 to 7.5% total return vs. 10 to 11%).

If you take the Monday 11/24 close at about 850, compared to this 425 at the end of 1995, it would be about a 5.5% return, not that much less than 1971 to 1995 return. If it were 6%, we'd be at about a 900 S&P. As the market opens this morning (11/26) the S&P stands at 843. Perhaps the average stock in the S&P is currently only about 5 to 10% undervalued.

My sense, however, is that this market has treated some stocks very unfairly while others may still be over valued. This should provide a great stock picker's market opportunity. This remains to be seen, however as most mutual funds are under performing their benchmarks by some of the widest margins I've seen. E.g. A sampling (although not purely random) of funds from a major highly respected mutual fund company shows under performance year to date in the 5%+ range.

Bold prediction: Let's assume the S&P is undervalued by 10% and that from there it gets 6% compounded per year. That would put it up 24% by end of 2010 or about 1050. Given the uncertainty and volatility in the market, one could easily imagine it trading in a +/- 25% range or 840 to 1300. This would provide huge opportunities for savvy traders. If one is disciplined and buys at the low end of this range and sells as the market approaches the higher end. There could easily be opportunities to make 20% or 30% multiple times over a period of a few years. In periods where the market is falling rapidly people will panic and think we're heading into another great depression (possible, but unlikely). Similarly euphoria will set in as the S&P approaches prior highs and people will think it's finally recovering, likely just to experience another set back.

I'm not sure how I feel about my own prediction and I don't think I can time the market. But I've lost confidence in Buy and hold as a strategy, as well.

Food for thought…………………………..