LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"In everything the middle course is best: all things in excess bring trouble to men."

- Titus Maccius Plautus
254 - 184 B.C.

Today's conventional wisdom states that common stocks are the financial asset of choice for any long-term investment program. Such thinking is reinforced in many ways. Numerous radio and television programs, books and periodicals feature "financial experts" espousing the virtues, indeed the necessity, of aggressively investing in equities if one expects a comfortable retirement. Many of these "experts" slavishly recommend allocating assets toward stocks, and away from bonds, based solely on average historical returns.

This is not the first time in our history in which the superiority of stock investing has been overly touted. For example, in 1924, Edgar Lawrence Smith, a New York investment banker, authored a book entitled *Common Stocks As Long Term Investments*. Originally, Smith set out to verify the conventional wisdom of the day; that being, stocks were the better investment during inflation, but bonds were the superior asset not only during periods of low inflation or deflation, but, also, over the long term. To his surprise, he discovered bonds were not the superior asset over the long term. Instead, his studies of the period, extending from the Civil War through the early 1920s, revealed common stocks to be the better performing asset. The book was widely debated, but generally praised by the noted economists and investment professionals of that time. As more and more investors embraced its conclusions, it became, in part, responsible for the great bull market of the 1920s.

An amplification of Smith's work is found in *Stocks for the Long Run* by Jeremy J. Siegel published in 1994. Siegel's study, covering the period from 1802 through 1992, corroborates Smith's earlier work. It shows, for example, that one dollar originally invested in stocks in 1802 with dividends reinvested would have become $3,050,000 by 1992. This is a compound annual return of 8.18%. Time and the power of compounding make wonderful partners. In contrast, according to Siegel's work, a dollar invested in bonds over the same time span with interest reinvested grew to $6,620, for a compound rate of 4.74%. The difference in the return on the two assets over 190 years is quite remarkable.

These two studies, like many others, concede that investors must be willing to accept the risk of greater price volatility from stocks over short periods of time. To overcome this inherent drawback of stocks, proponents demonstrate that the longer the holding period the less the likelihood of a loss. This concept is supported by a study done by Ibbotson Associates which showed that for any ten-year holding period starting with 1926 and ending with 1991 the chance of losing money on common stocks was very small. Their work indicated the worst ten-year period for stocks during those 66 years produced a -0.9% compound annual return. This occurred during the Great Depression. Siegel's study, over an even longer period, led him to conclude, "Although it might appear to be riskier to hold stocks than bonds, precisely the opposite is true: the safest long-term investment has clearly been stocks, not bonds."

We have several difficulties with the arguments which unequivocally favor an overly aggressive equity allocation based on the results from the aforementioned and similar studies. First of all, each of these studies assumes the investor is able to reinvest all dividend income. This is not practical in many instances. For example, many retired investors need this income, and more, to supplement their pension and Social Security. Unfortunately, if a stock market "crash" coincides with retirement there may not be enough remaining years to "repair the damage done," and the retiree may be forced to lower his or her expected lifestyle for the remaining retirement years.

A second point is that over the past fifty years, an ever-larger percentage of investors have come to embrace the long-term superiority of stocks. During the 1800s and up to the mid 1900s, investors did not accept this point of view as readily, as they do now. Toward this end, it is important to note what has happened to the relationship between stock and bond yields over the years. As investors gained confidence in equities during the post World War II bull market, they eventually became willing to accept a lower current yield from stocks versus bonds. This historical turning point occurred in 1958. Then, for the first time, the dividend yield of stocks became less than the yield of long-term bonds. Today, it is generally accepted that bonds should yield more than stocks and, in our opinion, supportive and compelling arguments continue to justify this relationship. The point is, however, the necessary adjustment to the relative valuation of stocks versus bonds has already occurred, and the future returns generated by the two asset classes may not be nearly so disparate as shown by the average returns derived from historical studies.

A final point concerns timing. The bulk of stock market returns during this century occurred during three major up cycles; the 1920s, the 1950-1960s and the current cycle. Based on results of the two previous cycles, aggressive allocation toward equities is more fruitful if such an investment stance is initiated before the beginning of an up cycle or, at least, in the early stage of the cycle. The initiation of an aggressive investment stance becomes increasingly dangerous later in the cycle. The worst timing experience would have been an investment at the peak in 1929. Despite the enthusiasm he shows for stocks, Siegel concedes, "It may have taken more than 25 years—until November 23, 1954—for the Dow Industrial average to surpass its 1929 highs. But because of the generous dividend yield on stocks during the 1930s, the waiting period for stock holders to recover their original investment was about 15 years."

The aforementioned points notwithstanding, we continue to subscribe to the view that stocks have an inherent advantage over bonds, and that stocks will continue to generate a superior return over the long term. However, we cannot slavishly accept the historical data and project these returns indefinitely. Given the volatility of the stock market, the now superior cash-in-hand characteristics of bonds, and our reluctance to blindly accept popular wisdom, we feel the prudent course is to construct portfolios which recognize an individual's needs, goals, objectives and unique tolerance for risk. From our experience, this necessitates some sort of balance for most portfolios.

October, 1995

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