LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> "Before investors can develop successful financial plans, they need to have realistic expectations of long-run stock returns. Although many individual investors expect the 15 percent returns of the past decade to continue, their expectations are not consistent with macro-economic fundamentals. If official estimates of the growth of capital, labor, and total factor productivity are approximately correct, macro-economic effects could actually reduce returns a little below their 10 percent historical average."
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> – John E. Golob and David G. Bishop

Over long periods of time, stocks have returned about 10 percent per year on average. During the past several years, stock returns have significantly exceeded their long-term historical average. Many interpret the recent market strength as the beginning of a new era, with above-average returns now the norm. Those with an eye on history are skeptical of continued 15 percent stock returns. A recent study entitled "What Long-Run Returns Can Investors Expect from the Stock Market?" by John E. Golob and David G. Bishop, published in the *Economic Review* of the Federal Reserve Bank of Kansas City documents their reasoning for such skepticism.

Although decade-long periods of high average returns are not unprecedented, these past episodes did not foretell any permanent rise in long-term returns. The 1920s was one such period. Another period was the 1950s when average 10-year returns were even higher than today, with a peak of more than 23 percent during the period ending in 1956. Each of these periods of superior returns were followed by lengthy periods of subpar results.

Also contributing to the new era thinking is the lengthy stretch of time since returns on market indexes have declined significantly in any one year. When analyzing American stock market history extending back to 1802, the post-1974 time frame is unprecedented. Prior to 1974, stocks usually declined significantly about every 5 years. Since 1974, declines in annual returns have been historically small.

An important constraint on long-term stock returns is the growth of corporate earnings. Stock returns consist of stock price changes plus dividend payments, and as Messrs. Golob and Bishop note, ". . . prices grow over the long run at approximately the same rate as earnings. For example, the S&P 500 index has grown 7.7 percent per year on average since 1922, while earnings have grown 7.6 percent per year on average." Hence, "If dividend yields remain in the vicinity of 2 percent, stock prices would have to grow 13 percent per year to generate 15 percent returns. As a result, earnings would also have to grow 13 percent per year, which is much faster than earnings have grown historically."

Interestingly, during this recent period of above-average stock returns, earnings growth has not accelerated. According to their study, "From 1982 to 1996 corporate earnings grew 7.8 percent per year on average, which is about the same as the 7.6 percent average rate over the past 75 years." They conclude stock returns have been above average during this period not because of an acceleration in earnings but because of a rise in price/earnings ratios.

The authors remind us that, "Economic output depends on three factors: capital, labor, and total factor productivity, which is a measure of how efficiently the economy converts capital and labor inputs into economic output." Recent and projected trends in capital, labor growth and productivity suggest a return on capital of approximately 10 percent. Some economic observers contend inflation is overstated, thereby deflating any measure of productivity and return on capital. If this is true, and productivity is growing one percent per year faster than generally assumed, ". . .capital currently returning 10 percent annually would return 10.5 percent annually after ten years." according to Golob and Bishop. They conclude, "Thus, even with higher productivity growth, the model does not predict that stock returns will rise to the vicinity of 15 percent. In fact, productivity growth would have to rise to about 6 percent [an eight-fold increase over recent rates] for returns to rise from 10 to 15 percent over the course of a decade."

The study concludes that forecasted economic growth does not support continued 15 percent gains in the stock market. Instead, fundamentals suggest that a continuation of recent economic trends could support returns in the neighborhood of 10 percent. Obviously, economic deterioration, e.g., a recession or an acceleration in inflation, would suggest significantly lower expectations. If this conclusion is correct, earning satisfactory returns in the future will become increasingly dependent on the identification of company specific developments and proper diversification and less dependent on technical factors and macro-economic events.

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