

What Kind of Return Can You Expect? Part I

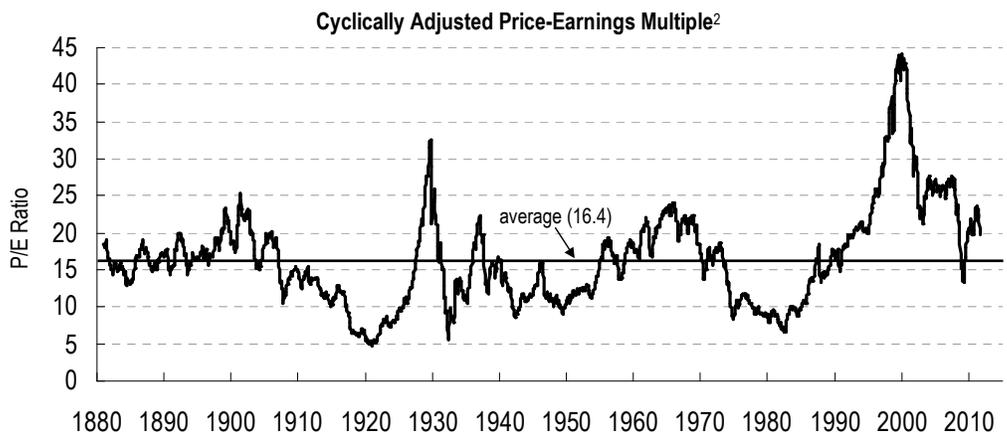
One of the most common, and important, questions investors ask is “What kind of investment return can I expect from my portfolio?”. The answer to this question informs much of what they subsequently do with their capital. As is the case in most important questions, the answer is not simple – but unlike in many other cases, there is a clear answer.

It is most meaningful to think in terms of ‘real’ or inflation-adjusted returns. As we have written in the past, equity investments win hands down. The table below tells the story.

	Value of \$1 invested in 1802 (inflation adjusted) ¹	Annualized real return
Gold	\$5	0.7%
Treasury bills	\$284	2.7%
Treasury bonds	\$1,177	3.4%
Common equities	\$655,000	6.6%

Owning equities protects wealth and generates more over time. Real returns of 6-7% (and nominal returns of about 9%) is the best starting assumption when thinking about long term returns.

However, this comes with one big caveat: the valuation of the stock market – the multiple that the market places on company earnings at any point in time – has an enormous impact on all but the longest term investment returns. Expanding multiples were the key driver of the long term bull market that ran from 1984 to 2000. The compound annual investment return during this period was 18.3% per annum, while the growth in earnings was 5.9% per annum. As you can see in the graph below, the multiple increased from around 10X in 1984 to over 40X in 2000! Clearly, the majority of the returns came from expanding P/E multiples, contributing about 10% a year over 14 years resulting in a quadrupling of P/E multiples. Obviously, this couldn’t continue forever and, in fact, had to revert back to more normal historical multiples at some point. This key fact seems to escape most investors. So many of them became spoiled from the strong returns in the 80’s and 90’s – returns that had never previously been earned throughout the 200 years of modern financial markets.



All figures based on US dollar data.

1. Siegel, Jeremy J. *Stocks for the Long Run, 4th Edition*. New York: McGraw-Hill, 2007. Returns updated to October 31, 2011 by Turtle Creek.
2. Shiller, Robert. *Irrational Exuberance*. Princeton University Press 2000, Broadway Books 2001, 2nd ed., 2005. Updated: www.econ.yale.edu/~shiller/data.htm. Shiller defines Cyclically Adjusted Earnings as a rolling 10 year average. Price and Earnings figures are adjusted to October 2011 dollars. Earnings and price data are taken from the S&P 500 since 1926 and from Cowles and Associates (*Common Stock Indexes*, 2nd ed. [Bloomington, Ind.: Principia Press, 1939]) before 1926.

Over the longer term, equities have outperformed other asset classes by a shockingly large margin.

Bull and bear markets come from earnings multiple changes, not changes in the growth of earnings themselves.



Similarly, compressing multiples have been the key driver of the long term bear market that we have been in since 2000. Just ask anyone who invested in the stock market in early 2000. Their return, including dividends, has been zero. It isn't often that investors earn no return over such a long period and this is why so many have 'given up' on equities. And yet, during this period earnings have grown by 5.2% per annum. The problem is, this growth in earnings has been more than offset by a greater than 50% contraction in P/E multiples.

Think of it this way: during the 16 year 'bull market' earnings grew at a rate of 5.9% per annum and during the 11 year (and counting) 'bear market' earnings grew at a rate of 5.2% per annum. Essentially, all of the 'bull' and the 'bear' came from earnings multiple expansion and then contraction.

But let's look at what happens if you adjust for this – if you hold the earnings multiple constant³. Looking over the past 200 years, it is possible to identify about 60 different periods where the beginning and ending price earnings multiples were roughly the same. The average length of time for these periods was 35 years – well within the period of time most people should consider when thinking about their family's wealth. Essentially, this analysis adjusts for the fact that, in the shorter term, the majority of stock market returns come from revaluations of companies and, instead, focuses on the longer term reality where the vast majority of returns come from the earnings and dividends of companies.

The results of this analysis are instructive. The average nominal (including inflation) return was 9.6%, in line with the overall 200 year returns; but what is noteworthy is the consistency of the returns – the standard deviation was only 1.6%. Essentially, long term returns are highly predictable for equities, once you adjust for earnings multiple changes. As an aside, the same cannot be said for other asset classes such as bonds where the standard deviation was almost as high as the nominal returns. Time transforms the short term 'volatility' of equity returns – the volatility that comes because public investors are constantly changing the multiple they place on company earnings – into remarkably 'stable' returns over a longer but manageable time period.

The obvious question that this raises is: is now a good time to be invested? Where are we today in terms of stock market valuation levels? Take another look at the graph on the prior page. The price earnings multiple has averaged 16 times – and today the multiple is 19 times. While the current multiple is much lower than ten years ago, it is still above the long term average and we could still face further multiple contraction to something below the long term averages over the coming years. The good news is that, at some point, growing earnings offset further multiple contractions and returns have to improve. And, at some point, the earnings multiple might actually expand, which, as we have seen, can contribute mightily to investment returns. Interestingly, the earnings yield of equities is becoming very attractive relative to long term bond rates. The earnings yield is 5% whereas the (10 year) bond yield is 2%. This ratio of 2.6:1 compares with the long term average of 1.8:1.

The reality is that no one knows which direction the markets will head in the next year or two (or five). But it has rarely been the case that equities have not been the right place to be. Indeed, it was only at two points during the 20th century when you were probabilistically better off not being in the stock market – 1929 and 1999. Otherwise, you were better to be invested in equities, and that is definitely the case today.

So after all of this, what kind of return can you reasonably expect? Well, if you own bonds or gold it hasn't been very pretty over the long term, and odds are it could be particularly ugly in the next decade or two for those asset classes. For equities, we are now very close to the long term average for stock valuations and, with that as your starting point, you can expect to do much better than other asset classes and earn high single digit returns – about 9% per annum (or 6 to 7% in real terms).

We will turn to Turtle Creek and our own return expectations in the second part of this series; but, to give you a sneak peak of our views, we believe that Turtle Creek can improve upon these broad equity market returns by at least a few hundred basis points and get our investors into double digit annual investment returns. Outperforming the stock market by a few percentage points a year over the long term can have a powerful impact on one's savings, as we will discuss in *What Kind of Returns Can You Expect? Part II*.

3. Peter L. Bernstein. *Financial Analyst Journal*, March/April 1997.

Long term returns are highly predictable for equities, once you adjust for earnings multiple changes.

Equities today are at the long term average valuation multiples.

