Reality Check on Investment Returns

By Gordon Clarke, O.L.S. (Retired)

From "dot.com" to "dot.gone" pretty well sums up the typical internet investment over the course of 2000. The NASDAQ, the U.S. stock exchange where many new technology companies are traded, fell by a record 39% over the calendar year. That is more than just a record drop for the NASDAQ, it is also one of the largest yearly percentage falls for any U.S. stock market ever. Was that a surprise? The fact that it went down at all might have caught a few new investors or day traders off guard, but the internet investment bubble was certainly there for all to see. The only question was when and by how much. In my last article for the Quarterly (Summer 2000), I examined previous investment bubbles and pointed out that history is rife with boom and bust cycles driven by the greed and fear of the marketplace.

Given the recent volatility, it might be a good time for a reality check on what investors should expect in the way of returns. While the NASDAQ (US$) posted 40% & 86% positive returns for 1998 & 1999 respectively and a 39% negative return for 2000, what should people hope to achieve from their equity investments over the long term?

There have been a number of interesting studies done on that very topic. Jeremy Siegel, in his book "Stocks for the Long Run", went back to 1802 in his study of capital markets in the United States. He found that over the period up to 1998, the equity market rose by an average compound nominal rate of 9.1%. When inflation was included, the "real return" was 7.1%. Of course these are averages and there were periods of high and low growth as well as high and low inflation which, over the short term, caused wide swings in stock market valuations. For example, Siegel's examination of the years from 1966 to 1981 illustrated how high inflation can ravage purchasing power. Over this period, while compounded investment returns averaged a positive 6.6%, real return was actually negative (-0.4%).

Bryan Taylor (Global Financial Data) looked at international markets in a 12 country study and one of his conclusions was, "evidence shows that over the long term, investors can beat inflation by 5-6% per year by investing in stocks". Canada's 6% after-inflation return from 1934 - 1995 was consistent with these findings. However, the fluctuations in some markets made the recent NASDAQ tumble look small. Taylor noted a pattern of corrections that produced declines in stock values of around 75%. Again, Canada showed a good example of this when the market took a severe 80% hit from a top in September, 1929 to the bottom in June, 1932. According to Taylor, an investment at the peak took until 1954 to regain the lost capital.

While the 39% hit on the NASDAQ was bad news for many investors and may even be a trigger for an economic slowdown or even a recession, it does come with a silver lining. Any correction, even a sectoral one like technology, serves to drive some of the excesses out of the market. The longer a bubble lasts the greater the pain when it ends. How many times during the past few years did you know people who talked about the performance of their stocks or funds? Are they still talking about it? John D. Rockefeller is rumoured to have exited the market just before the crash of 1929 because a shoeshine boy gave him a stock tip. For him it was a sure sign of a market peak. A correction serves to temper expectations. Simply put, investments cannot continue to double in value every few years. The value of a stock is related to the profits of the underlying company and without profits and the prospect of strong growth in these profits, share prices will not continue to rise at high rates.

But stock prices can get ahead of profits. After all there is nothing mystical about the price of a share. The stock exchanges are really only auction houses where stocks are sold to the highest bidder, and in theory they should be rational places where the fundamentals of a company and the economy govern investment decisions. Since this information is public knowledge, markets should be efficient and at any given moment stock prices should reflect all known information. The problem for investors is in translating this information into the "true" value. This is further complicated by emotion and even the market professionals get caught up in the hype. Thus, prices will get ahead of themselves and either drop precipitously as the NASDAQ did in 2000, or simply level off for an extended period until the fundamentals catch up.

In December, 1996, when Alan Greenspan, the head of the U.S. Federal Reserve became worried about stock market valuations and uttered his famous "irrational exuberance" comment, he only temporarily stalled a raging bull market. So while Siegel, Taylor and others continue to like the long term prospects of equity investments, Robert Shiller, who borrowed Greenspan's phrase in his book, "Irrational Exuberance" (2000), makes a strong case for caution. He agrees somewhat with Siegel but points out that when the fundamentals get thrown out the window, you can suffer quite badly in the short to medium term. After an in depth analysis of the markets he suggested that, "Taken as a whole, the present stock market displays the classic features of a speculative bubble: a situation in which temporarily high prices are sustained largely by investors' enthusiasm rather than by consistent estimation of real value."

Last year's "tech wreck" may serve to remind us that one of the old adages of investing may still apply. "Getting rich slowly" doesn't make great party chitchat, but it can make for a restful night's sleep.

Gordon Clarke is a retired OLS and an accredited Canadian Investment Manager. Gordon is a financial advisor with W.H. Stuart & Associates and can be reached at 1-800-590-2012.