Lowering your sights

The new math of stock returns indicates investors should downsize their expectations for 10 percent market gains

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DALLAS – Listen to stockbrokers or financial planners hawk their services and you will almost certainly hear words to this effect:

You can expect the stock market to return an average of 10 percent a year over the long term.

That statistic is trotted out with such certitude that most investors accept it as financial gospel. But can investors who start buying stocks today actually expect that kind of return over the next 10, 20 and 30 years?

"From 2005, guess the length of time that is needed to assure the long-term average," said Ed Easterling, president of Crestmont Research, a Dallas investment research firm. "The answer – probably never."

Easterling is not alone in his effort to lower investor expectations. An increasing number of academics and financial experts believe market returns over the next few decades won't match previous decades.

A more realistic return – or, as Easterling puts it, a return that a rational investor can expect – is somewhere between 6 percent and 7 percent. The Leuthold Group, a Minneapolis research firm, also estimates long-term market returns in that range.

"It's unreasonable for investors to expect double-digit returns," said Eric Bjorgen, senior research analyst at Leuthold. "Too many investors tether their expectations to what happened in the last 20 years, but that's not likely to happen again in our lifetime."

Three components contribute to total stock market returns: earnings, dividends and the change in stock valuations.

Historically, corporate earnings have grown 6.1 percent annually, and that figure includes an inflation rate of 3 percent.

Many investors have the skewed notion that the double-digit earnings growth in recent quarters is the norm. It's not.

As with stock market returns, the long-term future of earnings growth is likely to be below average.

"We got record earnings growth beginning in 2002 after one of the biggest bubble collapses in history in 2000," said James Stack, editor of InvesTech Research and a market historian.

"Just wait until the next recession when earnings growth turns negative again, and people will understand that earnings don't always grow 15 to 20 percent."

In any case, to even get to the 6 percent range, a healthy dose of inflation is needed. And that's anything but certain, because the Federal Reserve has become increasingly adept at controlling inflation.

Easterling predicts a low inflationary environment that will reduce the earnings contribution to long-term stock returns by 1 percentage point. That takes the average annual market return from 10.4 percent to 9.4 percent.

The second component of stock market returns – dividends – has accounted for a sizable portion of returns over the years. In fact, the average dividend yield of the S&P 500 since 1926 is 4.5 percent, according to Ibbotson.

(Dividend yield is the annual cash dividend that companies pay their shareholders divided by the stock price. A company that has a stock price of $10 a share and pays a 45-cents-a-share dividend has a dividend yield of 4.5 percent.)

Investors shouldn't count on a 4.5 percent dividend yield in the future, though, because stock prices are much higher now relative to earnings than they were in the past. To better understand this, consider the company above with the $10 stock price and 45-cent dividend.

If the stock price climbed to $20 a share, the company would still be paying the 45-cent dividend, but the yield drops to 2.3 percent because the stock price is higher. It's simple arithmetic.

The stock market today is more expensive than it was 79 years ago. The way this is determined is by looking at the market's price-to-earnings (P/E) ratio. The P/E ratio is a company's share price divided by its earnings per share.

For example, a company with a $20 stock price and $2 per share in earnings has a P/E of 10.

In 1926, the price-to-earnings ratio of the S&P 500 was 10. Today it is 19, or about double. In other words, today you pay about twice as much for every dollar of earnings.

"That explains why dividend yields today are about half of what they were 79 years ago," Easterling said. "So the market's return from dividend yields will be about half of the historical average as long as valuations stay at this level."

And that takes the average annual market return from 9.4 percent to 7.2 percent.

The third and final component involves the change in stock prices, or valuation.

As mentioned above, the valuation of the stock market almost doubled from 1926 to 2004, with the P/E of the S&P 500 moving from 10 to 19.

This growth in stock prices contributed almost 1 percentage point of the 10.4 percent return, according to Ibbotson.

The problem for investors looking for that same contribution going forward is that the market P/E has to double from the present level to about 40.

The likelihood of that happening is very slim.

Peng Chen, director of research at Ibbotson, points out that the P/E of the S&P has been over 30 only twice – in 1929 and 1999.

"Some people believe that the market P/E will just keep expanding. It can't; there's a limit," he said. "It's not reasonable to assume that someone is going to pay 30 to 40 times the annual earnings for a stock. At some point you would have stock returns greater than the nation's gross domestic product."

In fact, there are a number of economists who predict that the P/E levels will retreat toward 15, which is the historical average.

In any case, the current market P/E is historically high, so it's reasonable to assume that investors won't get the 1 percentage point contribution to returns that they got in the past.

And that takes the average annual market return down to Easterling's estimate of 6.2 percent.

Other models predict a slightly higher return, but the point is that investors should be realistic about their market expectations.

"If investors believe they are going to get 10 percent returns, they have to believe that we are going to have another bubble," Easterling said. "And if history is any guide, it may be another 70 years before we see another bubble."

So what's an investor to do?

Unless you think you've got some can't-miss strategy that will beat the market averages decade after decade until you retire, there's just one thing you can do.

In the equation of retirement savings, there are only two components to growth: your percentage returns and the amount you save into your account every year.

If your returns are likely to be less than expected, the only way to keep up with your retirement goals is to increase the amount you're saving.

"In an environment of lower returns, a greater responsibility falls upon investors to save more to make up the difference," said David B. Ackerman, a partner at Ackerman Capital Management in Dallas. "It's the one thing an investor can control."