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Creating Realistic Return Expectations

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Is it realistic to expect high double digit returns like those of 2003, or should our expectations be more conservative? While the truth is that nobody can be certain what future returns will be, setting reasonable expectations is necessary for planning purposes.

When formulating return expectations, it is important to understand the elements of investment return: earnings growth, dividends, and price multiples. By purchasing stock, an investor acquires the right to a share of that company's earnings and dividends. Her returns are driven by the company's earnings growth, dividend payments, and the amount that other investors are willing to pay for that cash flow.

The amount that others are willing to pay for a company's earnings may be represented by the stock's Price-to-Earnings (P/E) ratio, which is calculated as *share price ÷ earnings per share*. Historically, the stock market has had a P/E ratio of about 15 to 17, which means that investors have paid an average of \$15 to \$17 for every dollar of corporate earnings.

During the stock market bubble, the P/E ratio on the S&P 500 rose from 17 to more than 35, which indicates that a great deal of investment return during that time resulted from an expansion of price multiples as opposed to fundamental earnings growth. In fact, P/E ratio expansion increased returns by more than 13% per year from 1995 through 1999. The P/E ratio of the S&P 500 currently stands at about 23, which is still above average and is why many analysts suggest that stocks remain expensive.

Persuasive arguments can be made to support the current P/E ratio – lower trading expenses and investment related taxes, increased market liquidity, risk management benefits of diversification, use of financial derivatives to smoothen corporate earnings, etc... However, it is difficult to argue that higher P/E ratios are sustainable, and it seems unrealistic for investors to expect a further expansion of price multiples to boost investment returns (and it can certainly be argued that multiples may contract).

So where does this leave us? If P/E ratios remain constant, then investment returns should be limited to earnings growth and dividends. To approximate aggregate earnings growth, we can use the Gross Domestic Product (GDP) + inflation. Assuming long-term GDP of 3% to 4%, and inflation of 2% to 3%, a reasonable expectation for aggregate earnings growth might be 5% to 7%.

If we add the current dividend yield of 2%, expected aggregate market returns might range from 7% to 9%. This is slightly lower than the historic market return of 10.4%, but almost ½ of all 10-year annualized returns for the S&P 500 have been in single digits, so this expectation is certainly not unfounded.

If the aggregate stock market return is expected to be below average for the next few years, how can we enhance risk-adjusted portfolio returns? The following strategies should be considered:

1. Maintain exposure to small company stocks and value oriented (low P/E) stocks, which have historically provided excess returns of about 2% in addition to risk reduction.
2. Maintain exposure to international companies to take advantage of global economies, lower price multiples, and additional portfolio diversification.
3. Maintain exposure to alternative asset classes that provide inflation protection and diversification. Real Estate (REITS), inflation protected securities (TIPS), and commodities may apply.
4. Reduce "friction" by managing expense ratios and taxes, and limiting portfolio transactions in order to minimize trading costs. We have added flexibility to our rebalancing procedures to do this.
5. Create returns by saving aggressively...it is unlikely that the market will do as much of the work over the next 10 years as it did in the 90's, and investors may need to make up the difference.

Most importantly, remain focused on your goals and objectives, and disciplined in your investment approach. Market volatility is unlikely to go away, but long-term investors have historically been rewarded for their discipline.