

Creating realistic return expectations

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Since 1926, the average return for the stock market (S&P 500) has been approximately 10%. As a result, many investors presume double digit returns without giving much thought to how those returns are generated.

Is it reasonable to expect future returns to approximate the historic average, or should we have more conservative expectations? While the truth is that nobody can be certain what future returns will be, creating *reasonable* return expectations is necessary for planning purposes.

We believe that creating such expectations begins with a consideration of the primary components of investment returns: (1) earnings growth, (2) dividend yield, and (3) change in price multiples.

Fundamental returns: earnings growth and dividend yield

The first two components – earnings growth and dividends – can be thought of as the “*fundamental* components of investor return,” and are directly related to economic growth and corporate profitability. Other things being equal, a company’s stock becomes more valuable as the company’s earnings (profits) grow more rapidly.

Historically, earnings have grown at a rate of about 6.5% annually. There have been many periods of much higher or lower earnings growth, but growth seems to ebb and flow around this 6.5% average. This is also consistent with the notion that long-term earnings growth is somewhat capped by long-term economic growth (Gross Domestic Product, or GDP), which has typically averaged about 3.5% above inflation.

Dividends also play an important role in total return, and the dividend yield on the S&P 500 has historically averaged about 4%. However, while the dividend yield was as high as 9% in first half of the 20th century, the current dividend yield is about 2.3%. The reduction in dividends is attributed to a number of factors, and we do not believe that substantially higher dividends are a reasonable assumption.

Speculative return: change in price multiples

The term “price multiple” refers to the price that investors are willing to pay for a share of a company’s earnings. This is often measured as share price ÷ earnings, and referred to as the price-to-earnings, or P/E ratio.

Example: Microsoft has reported earnings (profits) of \$1.93 per share, and its stock is currently trading at \$26 per share, so Microsoft’s P/E ratio is 13.5 ($26 \div 1.93$).

When investors are optimistic about economic growth and/or have become less risk averse, they are often willing to pay more for a company’s stock, which results in a higher PE ratio. And when investors are pessimistic about growth prospects and/or increasingly risk averse, they may offer less for a company’s stock, which results in a lower PE ratio.

Note regarding PE ratios: The PE ratio is what many investors and analysts refer to when they say that a stock looks over or under valued. It is also used to compare the price of one company to that of another company...remember, since companies do not issue the same number of shares, each company’s shares represent a different ownership percentage, so comparing stock price alone does not provide the whole picture...it tells you the price, but not how much of the company that price purchases for you.

Putting the pieces together to create return estimates

Understanding the primary components of return (earnings + dividend + price multiple changes), we can create return expectation by adding together the expectations of each component.

Earnings: From an earnings standpoint, it is reasonable to expect corporate earnings to rebound from the depressed levels of 2008 and 2009, but we do not anticipate above average earnings growth after this rebound. That leaves us with estimated earnings growth of 5% to 7%, depending upon how well the economy recovers.

Dividends: The current dividend yield on the S&P 500 is 2.3%. This is below the long-term average dividend yield, but we believe that this remains a reasonable estimate.

P/E ratio: Based on projected earnings for the 2010, the PE ratio of the S&P 500 is approximately 16.5, which is in line with the historic average. While a case might be made for a slightly higher PE ratio, we are not comfortable counting on expansion from the current level (we would feel different if today's PE ratio was lower).

Using these estimates, we can build a return expectation as follows:

Projected earnings growth	5-7%
Projected dividend yield	2%
Projected P/E change	0%
Projected returns	7-9%

Based on these factors, our 3-5 year return estimate for the S&P 500 is approximately 7% to 9%. This is slightly lower than the historic market return, but about half of all 5-year annualized returns for the S&P 500 have been in single digits, so we do not believe that this expectation is not unreasonable. And we believe that it is a realistic and prudent projection given our current economic situation and market valuation level.

It is interesting to note the importance of starting valuation levels when estimating future returns. At average valuation levels, expectations are generally limited to earnings growth and dividends. If valuations are below average, as they were in March 2009, we would adjust our expectations higher to account for the possibility of expansion. And if valuations were much higher, as they were in the late 1990s, we would adjust our expectations lower to account for the possibility of contraction.

What to do about potentially below average expected returns

We realize that single digit stock market returns are not very exciting, and we hope that actual returns are higher through higher earnings (which are certainly possible), but we do not feel comfortable assuming above average earnings growth or PE expansion, and we cannot ignore the possibility of below average earnings growth or PE contraction.

So, if the aggregate stock market return is expected to be slightly below average for the next few years, how might investors enhance their risk-adjusted portfolio returns? First, we believe that the solution is not taking on more risk or reaching for returns that might not be there, which we believe may add a disproportionate amount of risk. Instead, we believe that investors should consider the following strategies:

1. Maintain exposure to small company stocks and value oriented (low P/E) stocks, which have historically provided excess returns of about 1-2% over the general stock market.
2. Maintain exposure to developed and emerging foreign markets in order to diversify economic and currency risk.
3. Maintain exposure to alternative asset classes that provide inflation protection and diversification benefits. Real estate (REITs), inflation protected securities (TIPS), multi-sector/high yield bonds, and commodities/natural resources may apply and should be considered.
4. Aggressively manage investment expenses and taxes, and limit portfolio transactions in order to

minimize trading costs.

5. Create returns by saving aggressively and maintaining realistic planning assumptions and expectations. While we do not envision returns being as anemic as the past decade, we do not believe that the market will do as much of the work over the next 5-10 years as it did in the 90's. Investors may need to make up the difference.
6. For retirees or those who rely on their portfolio to meet living expenses, we believe that maintaining a buffer equivalent to at least 3-5 years worth of projected investment distributions in cash and high quality bonds/bond funds is a prudent strategy.
7. 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.

We hope that you find this information interesting and informative. Please do not hesitate to contact us if you have any questions, or if there is anything that we can do for you.

Sincerely,

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