

SUNDAY MONEY

ECONOMIC VIEW

PETER L. BERNSTEIN

When the Long View Isn't So Scenic

THE subprime mortgage crisis and its ever-expanding aftermath have kept investors mesmerized about the present — and for good reason. But what do we see when we step away from today's turmoil and try to look into the future?

In the long run, we often hear, everything turns out well, so just hang in there. In the long run, the bumps will even out; main trends are identifiable; main trends dominate.

Yet, what use are these notes of hope when so many of us are struggling to survive in the short run? As John Maynard Keynes put it way back in 1923: "In the long run we are all dead. Economists set themselves too easy, too useless a task if, in tempestuous seasons, they can only tell us that when the storm is long past the ocean is flat again."

Keynes touched on a profound truth that will always dilute easy reassurances about the long run. Since the beginning of time, human beings have had to make decisions whose outcomes are clouded by uncertainty. We never

know what the future holds. It's just that simple.

In many cases, we cannot even guess the range of possible outcomes. We can learn from history, but, of course, history does not predict the future. Indeed, the long run is nothing more than a sequence of short runs. We spend most of our time navigating the tempestuous seasons.

Nevertheless, as Wayne Wagner, a market expert, put it recently, "We walk backward into the future, with our minds anchored by the imprinted lessons of the past." In the annals of equity investing, the long-run past has its fascination.

Looking back over the long run, we can see how the tempestuous seasons have disappeared and the seas have been relatively flat. A thousand dollars invested in the stock market in 1925, with all dividends reinvested, would have turned into almost \$3 million today. (Because of inflation, that would be worth \$250,000 in 1925 dollars.)

Over the 63 successive 20-year periods since 1925 to 1945, total



DAVID G. KLEIN

returns for common stocks (price change plus dividends) averaged 7.2 percent a year, after inflation; at that rate of return, your real wealth doubles in just nine years. There were no negative returns in any of those 20-year periods, and 15 of them scored total returns that were above 10 percent a year.

So why not hang in there? Shall this, too, not pass?

There are three reasons to answer no to these questions. Two rest on logic. The third derives

from history. In all likelihood, we will have to dip into our capital at some point, often at moments beyond our control — for example, to educate our children, to care for aging parents, to handle medical emergencies or to help finance our retirement.

We will never know in advance whether stock prices will be high or low when we have to sell some of our assets, but we will have no choice. Negative annual returns have occurred about 20 percent of the time since World War II. Unless you can sock your fortune away and forget about it, you are going to live in the tempestuous seasons.

Second, the history of the United States stock market over the past century or more is only one sample of many that might have occurred over such a long time span. Stock markets in Britain, France and Germany have had significantly lower long-run returns than ours. How relevant is the long stock market history of the United States to what will happen over the next 20 years?

The next 20 years will be far more a result of the past 20 than what happened in the distant past. History is not a random sample like throwing dice. History is a sequence of causes and effects. Just because something good, or bad, happened in the past is no basis for expecting — without a shadow of a doubt — that it will repeat itself.

Finally, all of this gleaming data has serious limitations. It assumes no taxes, no investment expenses and brokerage fees,

and 100 percent reinvestment of dividends.

And those dividends really matter. From January 1926 to December 2007, the monthly return from dividends exceeded the monthly return from price appreciation in two of every five months. Over the last 20 years, dividends have provided 39 percent of the total return.

BUT that was the past. Today, the dividend yield is only about 2 percent, compared with the long-run average of more than 4 percent since 1925. Achieving the long-run, inflation-adjusted annual return of 7 percent when starting with dividend yields of only 2 percent is a tough call, especially as earnings per share over that long run have grown more slowly than real gross domestic product, or only about 2 percent a year after inflation.

Even with an expanded foreign component, expectations of 5-percent-a-year growth in real earnings over the long run are risky, despite buybacks that would reduce the number of shares outstanding.

If such is the case, and I believe it is, the expectation of a long-run, inflation-adjusted total return of 7 percent a year from stocks may be little more than a lovely dream. Investing is much more complex than a replay of historical returns. The markets of the future will be determined by the tempestuous seas of the future, not by the past. □

FUNDAMENTALLY

PAUL J. LIM

Don't Paint Nest Eggs