

3 THINGS:

Returns, Nothing But “Net” & Overly Optimistic



What Drives Returns

A little over a year ago, [John Coumarios](#) penned a very interesting note with respect to the view that it is just “volatility” is driving prices.

"The great economist John Maynard Keynes once said: 'Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.'"

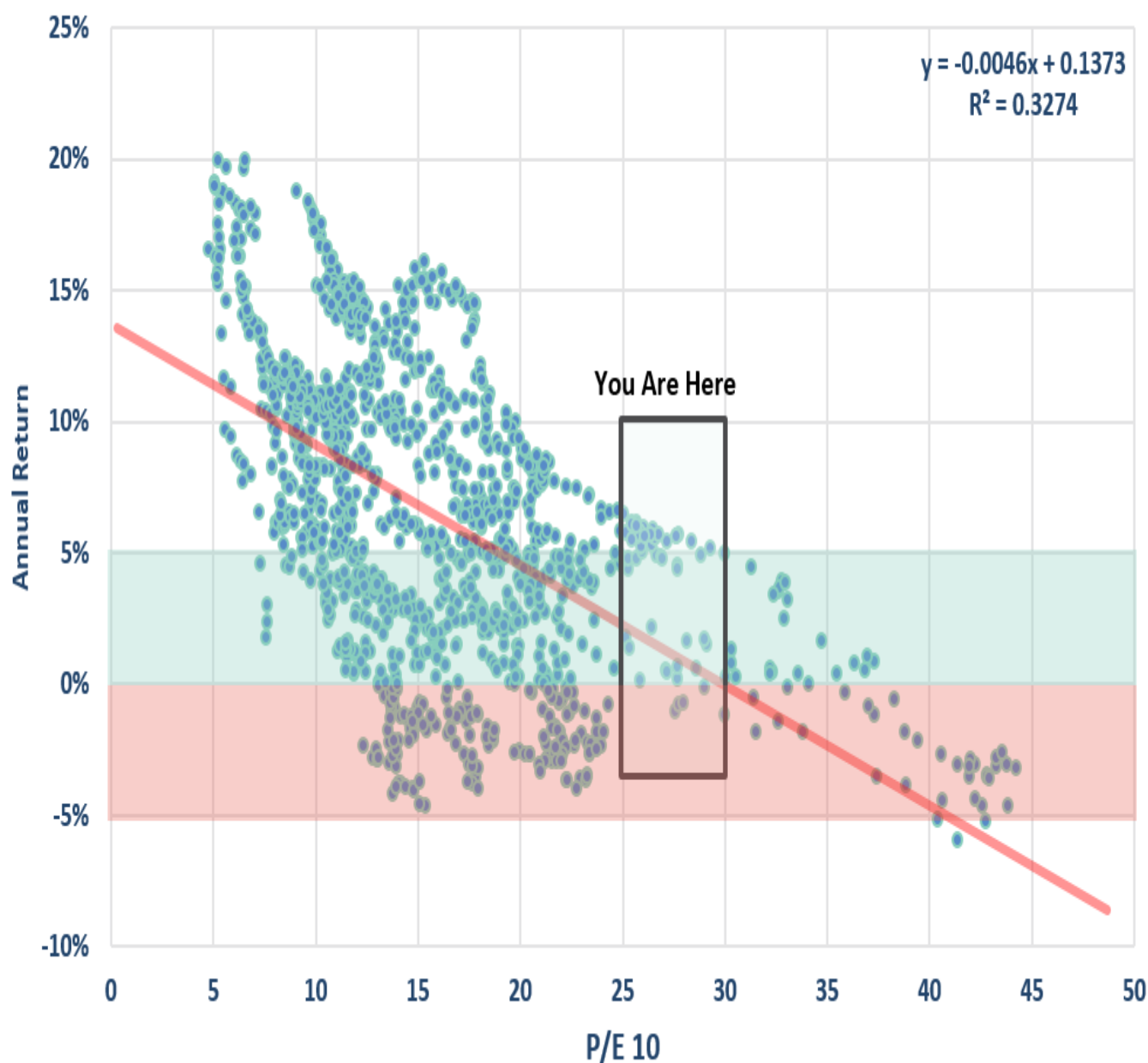
The point of his article was **debunking the idea investors who have the fortitude to withstand volatility in the markets will eventually be rewarded assuming increased volatility pushes asset prices higher**. The problem, which I addressed in Tuesday's post entitled the ["The Psychological Impact Of Loss,"](#) is the repeated **emotional mistakes made by investors which are ultimately driven by the very volatility investors are supposed to withstand**. But more importantly, **while the idea of "efficient markets" and "random walk" theories play out well on paper, they don't in actual practice**. What drives stock prices (long-term) is the value of what you

pay today for a future share of the company's earnings in the future. **Simply put - "it's valuation, stupid."** As John aptly points out:

*"Stocks are not magical pieces of paper that automatically deliver gut-wrenching volatility over the short run and superior returns over the long run. In fact, we've just had a six-year period with 15%-plus annualized returns and little volatility, but also a 15-year period of lousy (less than 5% annualized) returns. **It's not just volatility; it's valuation.** Instead of magical lottery tickets that automatically and necessarily reward those who wait, stocks are ownership units of businesses. **That's banal, I know, but everyone seems to forget it. And it means equity returns depend on how much you pay for their future profits, not on how much price volatility you can endure.**"*

10 Year Forward Annual Return From P/E Levels

REAL INVESTMENT ADVICE

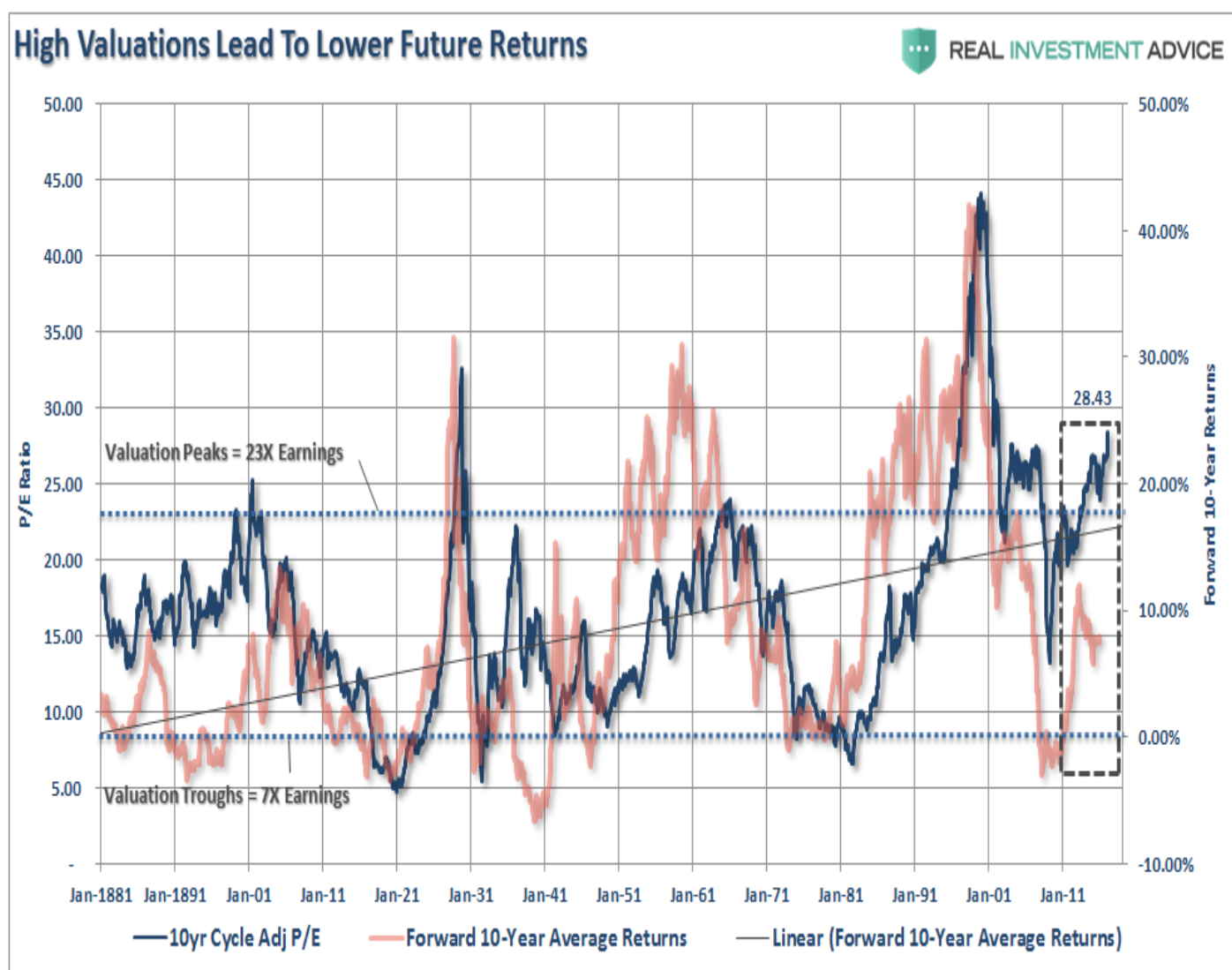


"And stocks are not so efficiently priced that they are always poised to deliver satisfying returns even over a decade or more, as we've just witnessed for 15

years. A glance at future 10-year real returns based on the starting Shiller PE (price relative to past 10 years' average, inflation-adjusted earnings) in the chart above•tells the story. *Buying high locks in low returns and vice versa. Generally, if you pay a lot for profits, you'll lock in lousy returns for a long time.*

Volatility is simply the short-term dynamics of "fear" and "greed" at play. However, in the long-term, as stated, it is simply valuation. [As I discussed in last weekend's newsletter](#), valuations are already pushing historic extremes which suggest lower future forward returns.

"With valuations at levels that have historically been coincident with the end, rather than the beginning, of bull markets, the expectation of future returns should be adjusted lower. This expectation is supported in the chart below which compares valuations to forward 10-year market returns."



"The function of math is pretty simple ? the more you pay, the less you get."

As a long-term investor, we experience short-term price volatility as "opportunity," and high prices as "risk." With earnings growth weak, and valuation expansion elevated, the risk of high prices has risen sharply.



Nothing But "Net"

One of the biggest myths perpetrated by Wall Street on investors is showing individuals the following chart and telling them over the "*long-term*" the stock market has generated a 10% annualized total return.

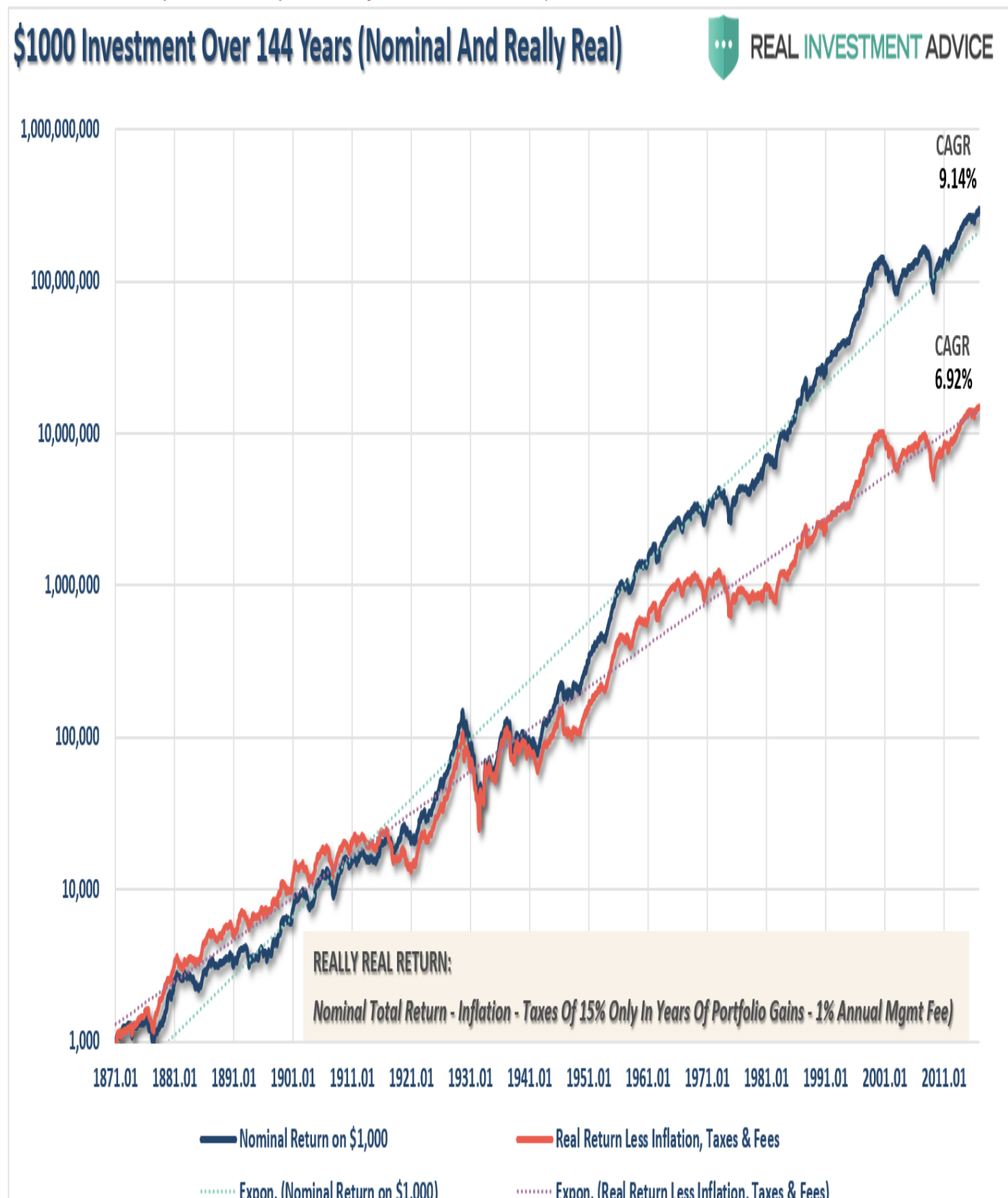


The statement is not entirely false. Since 1900, stock market appreciation plus dividends have provided investors **with an AVERAGE return of 10% per year. Historically, 4%, or 40% of the total return, came from dividends alone. The other 60% came from capital appreciation that**

averaged 6% and equated to the long-term growth rate of the economy. However, there are several fallacies with the notion the markets will compound over the long-term at 10% annually.

- 1) **The market does not return 10% every year.** There are many years where market returns have been sharply higher and significantly lower.
- 2) **The analysis does not include the real world effects of inflation, taxes, fees and other expenses** that subtract from total returns over the long-term.
- 3) **You don't have 145 years to invest and save.**

The chart below shows what happens to a \$1000 investment from 1871 to present including the effects of inflation, taxes, and fees. *(Assumptions: I have used a 15% tax rate on years the portfolio advanced in value, CPI as the benchmark for inflation and a 1% annual expense ratio. In reality, all of these assumptions are quite likely on the low side.)*



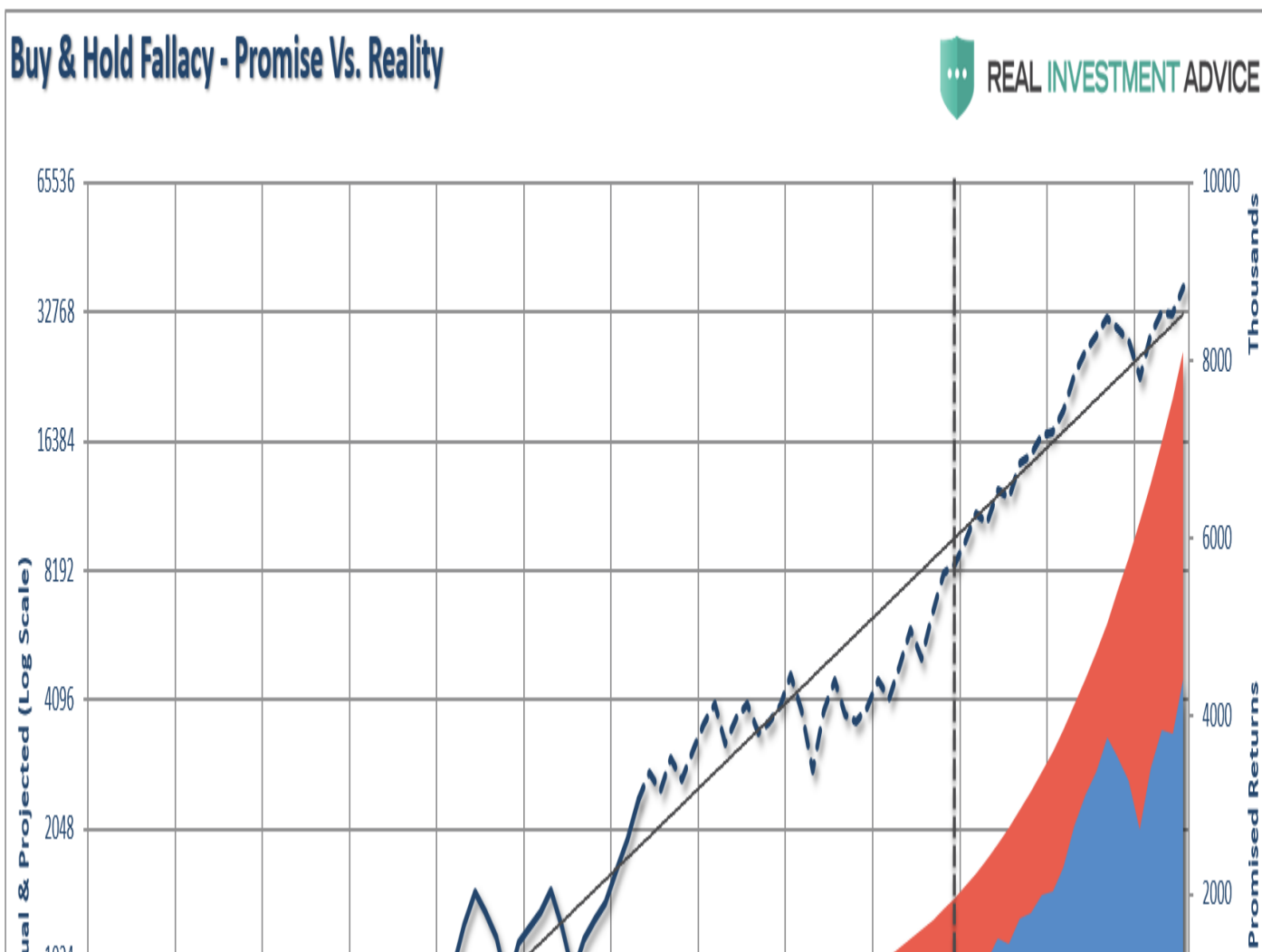
As you can see, there is a dramatic difference in outcomes over the long-term. **From 1871 to present the total nominal return was 9.15% versus just 6.93% on a "real" basis.** While the percentages may not seem like much, over such a long period the ending value of the original **\$1000 investment was lower by millions of dollars.** Importantly, the return that investors receive from the financial markets is more dependent on **"WHEN"** you begin investing with respect to **"valuations"** and your personal **"life-span"**.

Too Optimistic

Following on with the point above, with valuations currently at the second highest level on record, forward returns are very likely going to be substantially lower for an extended period. Yet, listen to the media, and the majority of the bullish analysts, and they are still suggesting that markets should compound at 8% annually going forward [as stated by BofA:](#)

"Based on current valuations, a regression analysis suggests compounded annual returns of 8% over the next 10 years with a 90% confidence interval of 4-12%. While this is below the average returns of 10% over the last 50 years, asset allocation is a zero-sum game. Against a backdrop of slow growth and shrinking liquidity, 8% is compelling in our view. With a 2% dividend yield, we think the S&P 500 will reach 3500 over the next 10 years, implying annual price returns of 6% per year."

However, there are two main problems with that statement: **1) The Markets Have NEVER Returned 8-10% EVERY SINGLE Year.** Annualized rates of return and real rates of return are VASTLY different things. The destruction of capital during market downturns destroys years of previous capital appreciation. **Furthermore, while the markets have indeed AVERAGED an 8% return over the last 115 years, you will NOT LIVE LONG ENOUGH to receive the same.** The chart below shows the real return of capital over time versus what was promised.



The shortfall in REAL returns is a very REAL PROBLEM for people planning their retirement. **2) Net, Net, Net Returns Are Even Worse** Okay, for a moment let's just assume the Wall Street "world of fantasy" actually does exist and you can somehow achieve a stagnant rate of return over the next 10-years. As discussed above, the "other" problem with the analysis is that it excludes the effects of fees, taxes, and inflation. Here is another way to look at it. Let's start with the fantastical idea of 8% annualized rates of return.

$$8\% - \text{Inflation (historically 3\%)} - \text{Taxes (roughly 1.5\%)} - \text{Fees (avg. 1\%)} = 3.5\%$$

Wait? What? Hold on...it gets worse. Let's look forward rather than backward. Let's assume that you started planning your retirement at the turn of the century (*this gives us 15 years plus 15 years forward for a total of 30 years*) **Based on current valuation levels future expected returns from stocks will be roughly 2% (which is what it has been for the last 15 years as well - which means the math works.)** Let's also assume that inflation remains constant at the current average of 1.5% and include taxes and fees.

$$2\% - \text{Inflation (1.5\%)} - \text{Taxes (1.5\%)} - \text{Fees (1\%)} = -2.0\%$$

A negative rate of real NET, NET return over the next 15 years is a very real problem. If I just held cash, I would, in theory, be better off. However, this is why capital preservation and portfolio management is so critically important going forward. There is **no doubt** that another major market reversion is coming. The only question is the timing of such an event which will wipe out the majority of the gains accrued during the first half of the current full market cycle. • Assuming that you agree with that statement, here is the question:

"If you were offered cash for your portfolio today, would you sell it?"

This is the "dilemma" that all investors face today - including me. Just something to think about.