How stable have common stock market returns been over time?

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How stable have common stock equity market returns been over time?Common stock equity market returns have varied widely in the past. The common stock equity risk premium has averaged about 4.1% from 1872 to 2000.The equity risk premium is the equity market return less the risk free rate of return. The risk free rate of return includes both the inflation rate and the risk free interest rate. When it is subtracted from the market return, the resulting figure is the real or non-inflationary equity risk premium. For more information about the risk free rate, Click Here >> How are asset class risk premiums and the risk free rate of return related?Measured by calendar decades over the past 130 years, common stock equity premium was over 10% in four decades, between 0% and 5% in seven decades and negative in two decades. Interestingly, for these calendar decades the risk premium was never between 5% and 10%. Instead, returns were most often relatively close to the average or they were a bust. The four exceptional high stock market return decades were the post-World War I and II periods and the 1990's economic boom period.In a related article, What have average investment asset class risk premiums been over long periods? it was noted that real or non-inflationary equity market returns have averaged almost 7% annually over the past 200 years. However, the composition of these equity returns has changed, as the average risk free interest return has declined and the corresponding equity risk premium has increased on average. Historically, both the risk free rate of return and the equity risk premium have fluctuated significantly. Table 1 below illustrates these patterns. Table 1 presents the annualized averages for each decade over the past 130 years. These data are selected from a table in “The Equity Premium” study by Professors Eugene F. Fama of the University of Chicago and Kenneth R. French of Dartmouth.1

Table 1 -- Historical Real Equity Risk Premiums (Compounded Average Annual Rates)

	Inflation (%/year)	(A) Risk Free Rate of Return*	(B) Real S&P Index Return	(B less A) Real Equity Risk Premium
1872-1880	-2.77	9.86	13.42	3.56
1881-1890	-1.72	7.23	5.08	-2.15
1891-1900	.18	5.08	9.15	4.08
1901-1910	1.95	3.18	6.78	3.60
1911-1920	6.82	.82	-.83	-1.64
1921-1930	-1.70	7.41	17.54	10.13
1931-1940	-1.23	2.80	7.52	4.72
1941-1950	6.04	-4.57	8.22	12.79
1951-1960	1.79	1.05	15.32	14.27
1961-1970	2.94	2.27	5.90	3.63
1971-1980	8.11	-.30	2.12	2.42
1981-1990	4.51	5.32	9.59	4.28
1991-2000	2.68	2.61	15.16	12.54

* RFR = interest rate for 6 month commercial paper rolled over at mid-year The 1920s, 1940s, 1950s, and 1990s were the decades with equity risk premiums that averaged in excess of 10%. The averages for the other nine decades were all under five percent. In two decades, the 1880s and the 1910s, the realized equity

risk premium was actually negative. It is useful to look at this long history to calibrate current expectations. We see from Table 1 that the last decade that had a negative equity risk premium was the 1910s, a period of substantial political and economic dislocations caused by World War I. The 1920s yielded a positive, double-digit equity risk premium. Near the end of that decade, some observers called this run-up in equity values a bubble. The 1920s market feast was followed by the Great Depression, and the U.S. experienced one of worst sustained economic periods in its history. Despite the Great Depression, the annualized equity risk premium for the 1930s was almost 5% as the economy slowly recovered. Clearly, positive equity premiums and popular misery can coexist. With the onset of World War II the domestic economy finally revived in the early 1940s, as the U.S. become the production arsenal of the Allied powers. The 1940s and 1950s are the only two decades with back-to-back double-digit equity risk premiums. At an average 14.3% equity risk premium, the 1950s was the decade with the strongest equity returns of this 130-year period. The economy was highly productive, while people aggressively reproduced and gave us the bulk of the Baby Boom generation. Again, a war in the 1960s influenced economic affairs, but this time negatively. The Baby Boom ended by the middle of the 1960s. With the stresses of the Vietnam War, the U.S. economy stagnated. Oil prices rose dramatically as OPEC instituted its embargo in 1973, and higher inflation took hold for more than a decade. As inflation receded during the 1980s, the U.S. economy began two decades of significant economic expansion. The 1980s and 1990s were characterized by two exceptionally long economic expansion cycles, interrupted in the middle only by a modest recession. The equity risk premium for the 1980s was average despite the fact that the equity markets experienced a sharp, albeit very short-lived correction in 1987. The 1990s were an outstanding decade from the standpoint of equity returns. Its double-digit equity risk premium was above that of the 1920s, on par with the market performance of the 1940s, and below that of the 1950s. Again, certain market commentators discussed a valuation bubble, as some had done near the end of the 1920s. A portion of the stock market feast of the 1990s was given back in the “dot com” market crash of the first few years of the 21st century. (For more information, Click Here >> What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s?)

These clickable links to related articles may also be useful to you: Returns and Risk Premiums: -> Asset class investment risk premiums -- your reward for taking investment risk ->What explains the recent common stock equity risk premium? ->How do individual investors’ recent portfolio return expectations compare to long-term historical common stock returns and equity risk premiums? ->To estimate the future common stock risk premium, how might individual investors extrapolate from the past? ->What common stock returns might individual investors expect going forward? ->What happens to the expected equity premium, when the common stock P/E ratio reverts toward historical norms? Securities Valuation: ->Introduction to investment valuation and securities risk ->How investment securities are valued -- snapshots in time ->The confusing investment securities market motion picture ->What is efficient market pricing in the securities markets? 1) Eugene F. Fama and Kenneth R. French. “The Equity Premium.” Center for Research in Security Prices, Working Paper No. 522; April 2001: 1-22, Table 2