

What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s?

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Summary: The long-term fixed income and equities markets of the 1980s and 1990s performed very differently than the markets of the past two centuries. Whether recent trends will continue or not is an open question with essentially unknowable answers. However, the longer history indicates that it would be reasonable to expect both fixed income and equity returns to be lower. A large number of recent scientific investment studies have focused on the equity risk premium paid by U.S. securities markets near the end of the 20th century. When compared to the previous one hundred and fifty years, real U.S. equity returns rose to an average of about 8% during the second half of the 20th century. Most of that increase was attributable to the 1980s and especially the 1990s, when annual real returns exceeded 15%. Some of these studies attempt to explain why the equity prices rose substantially in the 1980s and 1990s in certain markets. Other studies ask whether the equity markets were properly priced or over-priced. Some of this literature even asks whether — even after the market crash of the very early twenty-first century — equity market prices have yet adjusted sufficiently. Table 1 summarizes selected data from one of the numerous papers that have been written on historical returns.¹ Professor Jeremy Siegel of the Wharton School at the University of Pennsylvania has been especially prolific in writing about historical returns.² In particular, he has looked at the very long-term data and calculated summary information going back as far as 1802. Table 1 Real Annual Long-term Risk Free Rates and Equity Premiums (Source: [Siegel 2001])

Years	Total Real Equity Market Return (~S&P)			Short-term Risk Free Rate (T-bills)	
	Realized Equity Risk Premium over T-Bills	Long-term Risk Free Rate (T-bonds)	Realized Equity Risk Premium over T-Bonds	Long-term Risk Free Rate (T-bonds)	Realized Equity Risk Premium over T-Bonds
1802-2001	6.8%	2.9%	3.9%	3.5%	3.4%
1982-1999	13.6%	2.9%	10.7%	8.4%	5.2%
1982-2001	10.2%	2.8%	7.4%	8.5%	1.7%

Table 1 shows that during the two-decade period from 1982 to 2001, the fixed income markets produced relatively high 8.5% real “risk free” returns on US T-bonds. These high fixed income returns seem to be a short-term aberration against a backdrop of two centuries of generally eroding returns to long-term risk free T-bond rates. Compared to longer-term history equity returns were also relatively high, although the long-term equity risk premium did narrow due to the relatively high risk-free bond rate for that period. (See: [What have average investment asset class risk premiums been over long periods?](#)) From Table 1, it is also interesting to compare the expansion of 1982 to 1999 with the period 1982 to 2001. The period up to 2001 includes the expansion and the bulk of market bubble deflation down to a level roughly equivalent to the equity markets of mid-2005, the time that this article was written. Just adding 2000 and 2001 to the 1982 to 1999 period reduced the annual realized equity risk premium for these two decades by about 3.5%, while the short- and long-term risk free rates of return stayed relatively stable. Recent decades have also been

characterized by a dramatic transformation in the size and composition of the investing population. Prior to World War II, equity markets were the domain of a much narrower and relatively more affluent segment of the population. Equity investments were viewed by the middle class as highly speculative and a place where one could lose an entire lifetime of savings, as many did in the Great Depression. In the past several decades, the equity and fixed income markets have become vast storehouses of middle and upper middle class affluence across the developed world. Investment researchers have suggested that the wider availability of low-cost mutual funds and broader participation in the equities markets by individuals and institutions were factors in recently increased returns. Other factors may also have contributed, including: ->increased confidence in relatively stable macroeconomic growth ->better control of inflation via monetary policy ->new tax-advantaged retirement investment vehicles ->a shift toward defined contribution retirement programs ->increasing retirement concerns of the aging baby boom generation, and ->the entry of large numbers of less sophisticated individual investors into the securities markets. Whether the next twenty years will be similar to the past twenty years from the standpoint of fixed income and equity market returns, is the question weighing on many investor's minds. Its answer is essentially unknowable without, of course, waiting. The answer to this question will not be found in what people want to happen. It will be found in the economic opportunities and risks that either materialize and wreak havoc or melt away without causing significant damage to the world's private pocketbook. It will also be found in how this broader group of bondholders and shareholders react. Speculation about "correct" market pricing is fraught with problems. An investor needs to be careful when evaluating assertions that the markets are over-priced, under-priced, or priced just right. Even with an apparent bubble, you can only confirm or disprove whether it was a true bubble through subsequent market performance. Moreover, you might need to wait a very long time to measure subsequent performance. The scientific investment literature tells us that making definitive judgments in real-time about relative asset values and "correct" market pricing is generally futile. Goldilocks had opinions about the three bears' porridge being too cold, too hot, or just right. Investors who attempt to make similar judgments about current markets and decide to be in or out or to favor one asset class over another on speculation about incorrect market pricing are more likely to lose than win. Being in and staying in the market with an appropriate asset allocation would seem to be the better strategy - particularly given the inefficiencies fostered by the much higher costs and taxes associated with active management.

These 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 are asset class risk premiums and the risk free rate of return related? ->How stable have common stock equity risk premiums been over time? ->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) Siegel, Jeremy J., "Historical Results I" AIMR Equity Risk Premium Forum, November 8, 2001, Table 1 2) Professor Siegel has websites with interesting and useful information. See: [Professor Siegel's University of Pennsylvania - Wharton website](#)