How do return expectations of investors compare to historical stock returns and risk premiums?

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Summary: At the peak of the market bubble, many stock market participants had extremely high return expectations. The consensus of investment science is that the long-term equity risk premium is 4% to 5%. In the wake of an extended and brutal post-bubble bear market, investor return expectations in the second half of 2004 were much diminished. However, their expectations were still over twice as high as the long-term historical equity risk premium. What are reasonable expectations for future common stock investment returns? In the investment science literature, the equity premium is the excess return over the risk-free rate of return. (See: How are asset class risk premiums and the risk free rate of return related?) The level of the equity premium is of vital concern to investors, because of the tradeoff between risk and return. Over the 200-year period from 1802 to 2001, the real equity premium averaged 3.9% annually, although there were substantial variations from year to year. Over this period, there was a growth trend for the equity risk premium as it rose, and the risk free rate generally declined by a similar amount leaving the total real or non-inflationary return the same at just under 7%. (See: What have average investment asset class risk premiums been over long periods? and How stable have common stock equity risk premiums been over time?) While long-term historical returns are not predictive, they can provide useful guidance on the likely range of potential equity premium in the future. If investors did not expect excess returns from equities to compensate for the risk of holding them, no sane investor would hold them, because a risk-free alternative is available. Expecting a premium for taking on equity risk is reasonable. Therefore, the question is, “How much you should build into your planning?” (For additional perspective see: What common stock returns might individual investors expect going forward?) During the 1990s, the average investor felt very good about the realized equity return in their portfolios. The bursting of the market bubble from 2000 through 2002 ended this euphoria. However, current surveys indicate that many investors’ expectations may only have declined to a level that many analysts would still consider too high. Table 1 presents selected data from the Securities Industry Association’s annual Investor Survey of approximately 1,500 investors, which is conducted in the late summer of each year.1 The average and median annual expected percentage returns [columns (a) and (b)] are investors’ responses to the SIA surveys. The annualized 6-month T-bill rate data [column (c)] is from the Federal Reserve Bank, and it measures the short-term realized risk free return for these years.2 Finally, the risk free rate is subtracted from the SIA survey respondents’ average and median expected returns columns to derive their expected average and median equity premium percentages [columns (d) and (e)]. Table 6 4 –Investor’s Return Expectations and their Implied Expected Equity Premium (Source: Securities Industry Association’s Annual Investor Surveys)

Year (a) Average Annual % Expected Returns (b) Median Annual % Expected Returns (c) Annualized % “risk free” rates based on 6-month T-bills (d) Expected Average Annual % Equity Risk Premium (e) Expected Median Annual % Equity Risk

Premium

1999	30%	15%	4.8%	25.2%	10.2%	
2000	33%	15%	5.9%	27.1%	9.1%	
2001	19%	11%	3.3%	15.7%	7.7%	
2002	13%	10%	1.7%	11.3%	8.3%	
2003	10%	10%	1.1%	8.9%	8.9%	
2004	12.8%	Not Available	2.0%	10.8%	Not Available	

From 1999 through 2003, investors were asked the question, “How well do you generally expect your investments to perform?” In 2004, the survey administration vendor was changed, and so was the question that was asked. In 2004, respondents were asked, “What do you expect your investment return to be for the full-year 2004? That is the percentage change in the total value of your investment portfolio for the whole year.” Clearly, the exceptionally high equity returns of the 1990s had the effect of dramatically inflating investor expectations. At the peak of the market bubble, many market participants had extremely high return expectations. In 1999, 2000, and 2001 the difference between the average and median return expectation was about a two to one ratio. This difference demonstrates just how wild the dreams of some investors had become. Expectations diminished through the grueling collapse of the “new economy” stock market bubble. It took a grinding three-year bear market from 2000 to 2002 to bring return expectations down. By the second half of 2003, the average and median return expectations had converged at 10%. However, 10% was the bottom and expectations reversed and began to climb in 2004. Note that in the 2004 survey, investors were also asked the same question regarding their portfolio return expectations for 2005. For 2005, their average response increased 1.3% for a total expected portfolio return of 14.1%. Do post-bubble American investors now have realistic expectations for the future? The scientific investment literature indicates that they probably do not. In 2004, the equity risk premium expected by investors was 10.8%. The consensus of investment science is that the long-term equity risk premium is probably about 4% to 5%. Investor expectations in the second half of 2004 were over 2 times higher, and this was in the wake of an extended and brutal post-bubble bear market. Perhaps recent investors’ expectations help to explain why the market’s current average equity P/E ratio remains modestly above the long-term average of about 15. (See: What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s? and What happens to the expected equity premium, when the common stock P/E ratio reverts toward historical norms?) The disparity between the expectations of these SIA survey respondents and the scientific investment literature is striking. However, this imbalance may actually be even larger. Respondents were asked about their expectations for the performance of their overall financial portfolios rather than just their equities. The 2003 survey was the most recent survey to provide information on the proportion of equities, fixed income, and cash/equivalent investments in respondents’ portfolios. Just over half of respondents’ portfolio assets were in equities and the rest was split between fixed income and cash. In 2003, interest rates were at generational lows and since then have risen slowly, damping the growth in returns for fixed income securities already held in investors’ portfolios. It seems highly unlikely that respondents’ returns on the non-equity cash and fixed income portion of their assets will exceed 10%! To achieve the overall portfolio return expectations stated by these investors, the equity portion of their portfolios would need to grow at a significantly faster rate than their stated survey expectations. It seems that more than a little froth may remain in investor’s total return expectations. This could lead to some disappointment in the future, given that a sustained annual U.S. economic growth rate exceeding 10% would seem to be far out of reach.

These related articles may also be useful to you: Returns and Risk Premiums: ->Asset class investment risk premiums -- your reward for taking investment risk ->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? ->What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s? ->How do individual investors’ recent portfolio return expectations compare to long-term historical common stock returns and equity risk premiums? -> What explains the recent common stock equity risk premium? ->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) Securities Industry Association. Annual SIA Investor Survey: Investors’ Attitudes toward the Securities Industry. Harris Interactive (11/2003), Wirthlin Worldwide (11/2004)

2) Federal Reserve Bank, Federal Reserve Statistical Release H.15: Selected Interest Rates. See this link to the Federal Reserve Bank.