What common stock returns might individual investors expect going forward?

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Summary: Obviously, no one really knows or can know what common stock returns will be going forward. Using rationally based estimates of the forward-looking equity premium, investors should probably not expect anything like a repetition of equity market returns during the 1980s and 1990s. Performance in those decade was simply exceptional and not the norm. U.S. stock market returns during the 1980s and 1990s were quite exceptional and not likely to recur soon, despite a moderation of valuation caused by the bubble crash. In particular, investors should probably not expect a repeat of 1990s stock market performance. From 1991 to 2000, the average annual realized equity premium was 12.54%.1 (For some historical perspective on market returns, 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?) Instead, to expect something close to much longer-term historical measures is probably more reasonable. While the recent bursting of the market bubble certainly tempered many investors’ expectations, equity premium forecast studies and the Securities Industry Association’s annual surveys indicate that a large number of persons may still require additional and major downward adjustments to their expectations. (See: How do return expectations of investors compare to historical stock returns and risk premiums?) Many current individual investors first entered the U.S. equity markets after 1980. Younger persons moving on toward middle age, saved, and took up investing. Some middle-aged and older investors ventured for the first time into equities. During this period, more equity investment opportunities were made available to individual investors through defined contribution plans, tax advantaged retirement plans, discount brokerage accounts, and other investment vehicles. Relatively new equity investors had only known a period of unusually high equity returns, until the nasty wake up call when the market bubble burst. As a result, they have had relatively high, although somewhat recently muted, expectations. What is the reality about future returns? There is none – at least not yet. In rational forecasting, you should only make personal judgments based upon verified historical models. To evaluate the longer-term risks to the equities markets, you need to consider whether the economic, monetary, market, political and demographic factors that were at work during the past twenty-five years are likely to increase, persist, revert mildly, or change dramatically. Despite the recent stock market crash and partial recovery, a large number of investors seem to continue to interpret an unusually high twenty-year growth trend as being the norm, which historically it was not. Older individual investors with much longer investment track records know that equity returns have not always been so rich and that the stock market has a perverse way of periodically punishing naiveté. The Skilled Investor hopes that there are other ways for younger investors to gain investment skill and wisdom without needing to grow old and have the equity markets smack them in the face repeatedly in between the good times. (See: What should you look for in the financial media to improve your personal investment skills?) Given this long history of equity return premiums, what might one expect for the future? It would seem that over very long periods the equity markets have delivered very substantial rewards for taking on the risks equity ownership. This, however, has been a cycle of feast and famine with periods of modest, but still positive returns mixed in. Perhaps the only guess that one might make of the future equity premium is that, over the long run, it might be similar to the very long-term average of the past. Unfortunately, the future is entirely unpredictable. There is no evidence in the scientific investment literature that amateur or even professional investors can profitably predict when the securities markets will reverse. Nor are they able to determine when to rotate between industrial sectors or asset classes and thereby beat the market. In fact, the opposite seems more true. Furthermore, the extra costs, higher taxes, and significant time commitments associated with active asset sector rotation strategies make success even more unlikely for the average investor. The Skilled Investor believes that investors simply need to understand their risk tolerances and, through personally appropriate asset allocation decisions, expose themselves to the risk of the broad equity markets. They should adopt a broad market index strategy via mutual funds and exchange-traded funds, while they keep costs, taxes, and time to the bare minimum. In the past, there has been a substantial reward for exposure to equity risks, albeit with wide swings. Substantial rewards for equity risk exposure in the future are very likely – again with wide swings.____

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1) Eugene F. Fama and Kenneth R. French. “The Equity Premium.” Center for Research in Security Prices, Working Paper No. 522; April 2001: Table 2