

# A Surprising Bear Market Lesson about Bullish Projections

David Gulley<sup>1</sup>

The recent turmoil in stock markets has caused shell-shocked investors and financial professionals to cast a jaundiced eye on historical equity returns. The ten-year period of January 1999 through December 2008 has been called the “lost decade” of investing, since most stock indices are negative for the period. Should pension plans and other investors scale back their assumptions about future stock market returns? Surprisingly, the answer may be “no.”

In the present climate, investors can easily fall into the trap of assuming historical returns are just historical returns, and as they say in mutual fund promotional materials, the past is no guarantee of future success. But what if historically high stock market returns are *not* just a remembrance of things past – what if such returns actually constitute an equilibrium condition demanded by investors and enforced by markets? As corporations struggle to rebuild their balance sheets and pension plans cope with present and future needs, they should understand that the stock market crash might actually *validate* the use of historical stock market returns in assessing funding needs.

One of the most consistent empirical findings of economics is that stocks out-perform bonds over the long run. And yet, in a historical analysis ending at the trough of the current bear market (April, 2009), some bond portfolios out-perform stocks over one-, five-, ten-, and even twenty-year horizons. Should we therefore conclude that equity returns have entered a new and disappointing era? Probably not: the stock market rallied decisively off that low, of course, but that is not the best reason. Periods when bonds out-perform equities are anomalies; they require a cherry-picked start or end date. If one selects the start and end dates at random or uses a cross-section of dates, higher equity returns are generally in evidence. The consistency of this

tendency is the story here – it isn’t just for a select few time periods, a certain combination of underlying economic trends, or even a particular stock market or national economy. The consistency runs too wide and too deep to be readily explained as a chance result. The best explanation of the phenomenon is that markets demand an “Equity Risk Premium.” This is an additional return on capital demanded by investors to compensate them for the higher risks of equity investment compared to bonds. It is an equilibrium condition directing the flow of capital between the two alternative forms

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*“By validating the Equity Risk Premium, the bear market actually affirms the use of historical rates of return.”*

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of investment. If stock prices are too high, more money will flow into safer investments, because a top-heavy stock market is likely to under-perform. If stock prices are low and bargains abound, money will flow out of bonds into equity. Since markets are also influenced by short-term considerations both rational and emotional, this simple dynamic is only obvious over longer periods of time, measured in years.

From day to day, the market’s expectation of future returns will change. And these are only expectations – the market may be efficient, but it isn’t infallible, and actual returns will vary. Nevertheless, a careful review of the history of past returns should lead us to the historical premium that was actually paid out to investors to keep the mix of stock and bond investments within historical norms. This is not a difficult calculation. In principle we merely subtract the return on bonds from the return on stocks. (Naturally, there are a few subtleties to take into account, such as controlling for inflation.)

Estimates of the historical equity risk premium will vary with the time period selected, but researchers frequently report results of 6 or 7 percent or more. (This is the premium over bond market real returns, by the way, not the total rate of return on stocks, which of course is higher.) This has been the case for more than a hundred years. And it applies internationally. Annual deviations from this norm can of course be large. For a planning period of a single year there is about one chance in four that the gap will be much more favorable for stocks, between 8 and 14 percent, and also about one chance in 20 that the gap will be negative, i.e., bonds will outperform stocks.

Which brings me to my central point: recent events do not *deny* the validity of expectations of moderate stock markets returns – they *confirm* it. Until the stock market decline and crash of 2007-9, the observed equity risk premium was considered a “puzzle.” Why would the stock market demand such a high risk premium, when there was scant evidence the risks were really so high? After all, research had shown that the stock market had returned on average more than double the return on bonds. Why wouldn’t equity returns be depressed by the flow of smart money out of bonds and into equities? The matter was debated amongst professional investors and researchers, and various explanations were advanced. The explanation that seems most plausible today is that there really are major risks to equity – painful and protracted market declines that are rare but brutal. The market evidently understood this all along, and demanded a correspondingly rich premium.

By affirming the validity of the equity risk premium, the recent bear market lends further support to the use of this tool in evaluating investment portfolios. In other words, tabulating historical returns is not merely an empirical exercise of uncertain future

1. The author is an economist and Managing Director at Navigant Consulting, Inc., in New York. The article draws upon his testimony in court cases about pension planning. The author wishes to thank Justin Regus, Kris Peterson, and Mike Marley for their comments on this paper, but the views expressed herein are his views and not necessarily those of Navigant Consulting or any other individual. This article does not constitute investing or consulting advice.

applicability, but rather is a means of quantifying a fundamental feature of financial markets. Particularly when contemplated at beaten-down share price levels and the current low bond yields, it is rational to expect a reversion to the long-term relationship between stocks and bonds. Of course, as a matter of probability the hundred year flood can happen two years in a row. When confronted with such disasters, it is understandable that a risk-averse public urges greater precautions. But such sentiment, grounded in painful recent experience, needs to be balanced by an unemotional study of the evidence.

Not every economist believes in the concept of an equity risk premium; not all who accept the concept think it is stable over time; and not everyone who does the math arrives at the same number. While both sides in a lawsuit might agree on a number, the parties could also easily disagree, and the court may wish to consider expert testimony that applies the concept to the facts and circumstances of a given case.

Be that as it may, a substantial and objective body of evidence shows that equity returns are reliable in the long term – not just the arithmetic result from happy past

performance, the premium is actually a *requirement* enforced by the market's ability to deny money. Pension plan advisors and other investment professionals and fiduciaries would be just as wrong to disregard the equity risk premium as they would be to assume the future will be one long, uninterrupted bull market. Regret can be a useful emotion, but it can also overwhelm – a hard-headed examination of the past is still the best guide to the future.