



## Real Return Expectations

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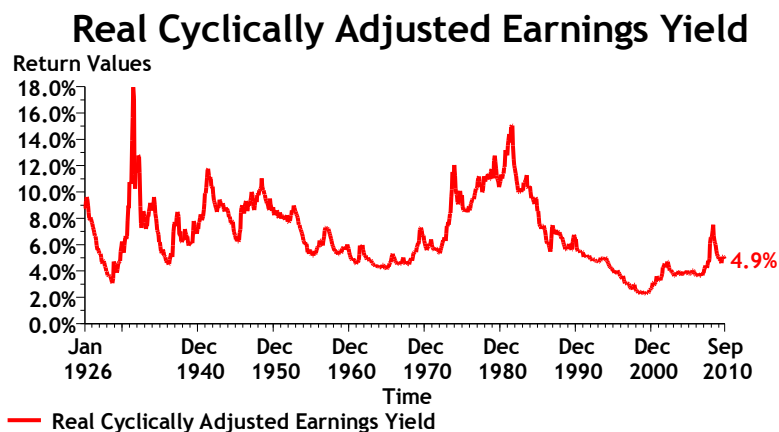
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There is nothing more important to long-term investors than real returns. Real returns – returns net of inflation - are what eventually fund consumption. The inflationary component of returns only offsets price increases.

Investors can lock in a certain real return through Treasury Inflation Protected Securities (TIPS). The principal value of TIPS increases with inflation (or decreases with deflation) and interest is paid bi-annually on the adjusted principal. At maturity, investors are paid the adjusted principal or original principal, whichever is greater. Unfortunately, the current yield on a 10-year TIP bond is a paltry 0.74%, far below its average since 2003 of 1.9%.

Unlike TIPS, the future real cash flow from stocks is uncertain. However, a number of academic studies<sup>i</sup> have found that long-term real returns are somewhat predictable as stock market prices exhibit a tendency to revert to levels determined by fundamentals such as corporate earnings. In this regard, the following exhibit sets out the real earnings yield – the inflation-adjusted, 10-year smoothed earnings divided by price – of large company U.S. stocks since 1926<sup>ii</sup>.

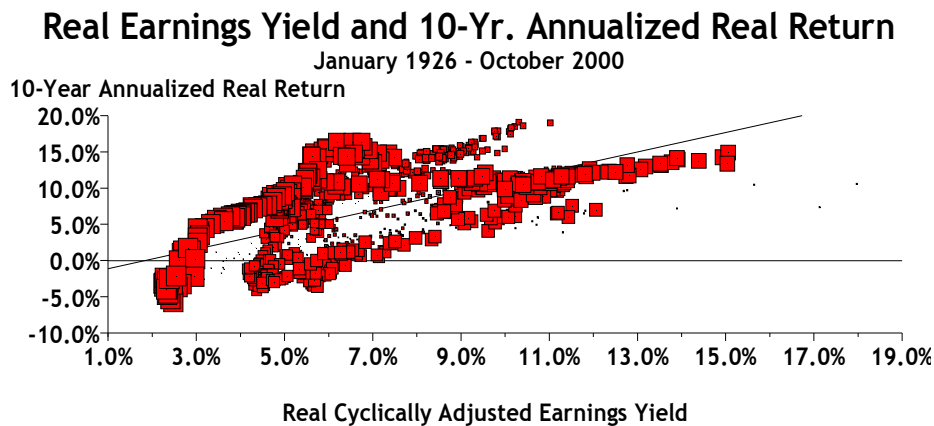


Since earnings are the engine that drives both dividends and capital gains, the real earnings yield is a useful valuation measure of stocks. As illustrated, the real earnings yield as of September, 2010 is 4.9%. In essence, investors in U.S. large company stocks today are prepared to pay \$1.00 for every 4.9 cents of real earnings. This is substantially higher than the record low yield of 2.3% in December, 1999 when euphoric investors



pushed stock prices to delusional extremes during the technology boom. However, it is well below the long-term, average real yield of 6.7%.

Low real earnings yields historically have been associated with lower, real (i.e. inflation adjusted) stock returns in subsequent years. Conversely, high real yields have been associated with higher realized real returns. This is illustrated in the following scatter diagram which compares the monthly real earnings yields of large company U.S. stocks from January 1926 to October 2000 with the annualized real return actually earned over the subsequent ten years.



The upward slope of the graph clearly illustrates that as real earnings yields increase so does the real annualized return over the subsequent ten years. However, there is a dispersion of return outcomes related to most yield levels because market valuations can stay at extremes – either high or low – for protracted periods of time. Also, the return of any ten-year period is heavily influenced by the state of that market at the end of the 10 years. For example, negative real returns are most frequent when the ten-year period terminates in a bear market.

Statistically, the current real earnings yield results in an expected real annual return over the next ten years of 4.1%, well below the historic norm since 1926 of 6.6%. In essence, this 4.1% forecast reflects the stock market gradually reverting to its long-term normative valuation. Should valuation levels remain above the long-term norm or even increase from today's levels, the expected annual real return might reasonably range up to a high of 6.3%. Conversely, a trend to lower valuations might result in real annual returns as low as 2.0%.

Regardless, the message is clear. At today's valuation levels, long-term real returns from U.S. large company stocks are going to be in the low to mid single digit range. And mind you, these returns are before the drag of costs and taxes. For investors in or approaching retirement, such return prospects are daunting.



Investors seeking higher returns will need to go farther afield. Historically, both value and small company stocks have provided return premiums to the market overall. (See our Commentaries - [Beating the Market](#) and [Good Things Come in Small Packages](#). High-dividend yielding stocks have also historically earned a premium to the market<sup>iii</sup>. Emerging markets may offer the opportunity for higher returns. Moreover, the potential devaluation of the U.S. dollar to emerging market currencies might even enhance such returns.

High net worth investors may want to look at certain alternative investment strategies including longer-term, illiquid investments. The heightened return potential of such strategies is not a free lunch. It reflects their unique risk characteristics – leverage, credit, tail risk and illiquidity. Yet, carefully selected, such strategies have the potential to both augment returns and diversify portfolios.

Thoughtful investors need to come to grips with the low real return potential of the broad stock market. They then need to robustly diversify in pursuit of potential return premiums.

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<sup>i</sup> See, for example, Campbell, John Y. and Robert J. Shiller. 2001. "Valuation Ratios and the Long-Run Stock Market Outlook: An Update." Cowles Foundation Discussion Paper No. 1295. Cowles Foundation for Research in Economics New Haven: Yale University. March.

<sup>ii</sup> The real cyclically adjusted earnings yield has been derived from Shiller's cyclically adjusted price earnings ratio available at <http://www.irrationalexuberance.com/index.htm>.

<sup>iii</sup> See, for example, Dimson, E., Marsh, P. R., and Staunton M. (2002). *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton, NJ: Princeton University Press