Evoke | ARIS Insights: A Brief History of US Stocks

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The S&P 500 has averaged over 13% per year during the past 10 years making US stocks one of the best performing asset classes.[1] Most portfolios are overweight US stocks and there seems to be little interest to change course given recent results.

The goal of this month's *ARIS Insights* is to zoom out and offer investors perspective on longer-term performance of this currently favored asset class. It may seem that US stocks only go up and the occasional drop is quickly propped up by policy makers and investors waiting for a dip. However, a review of history reveals that 1) long-term returns are probably lower than investors realize, 2) the past 10 years is an anomaly, and 3) performance over the next 10 years may be challenged.

Long-Term Returns

Over the past 100 years US equities have earned an average of 9% per annum.[1] Importantly, this commonly quoted figure is made up of two core components: the return of cash and a total return premium above cash for taking risk. If an investor took zero risk over the past century and put all their money in cash, the investor would have earned about 4% per year.[1] Therefore, stocks shouldn't be given credit for the entire 9% total return, but only the excess above the risk-free rate. Thus, the long-term return can be more accurately quoted as cash + 5%.

Maybe 100 years is too long a reference point for some investors. After all, one may argue that conditions that drove markets many decades ago are unlikely to be relevant today. Regrettably, the numbers do not change much when we focus on the past 20 years. US stocks delivered 6% total returns per year with cash gaining 2% resulting in a cash + 4% 20-year stat line.[1]

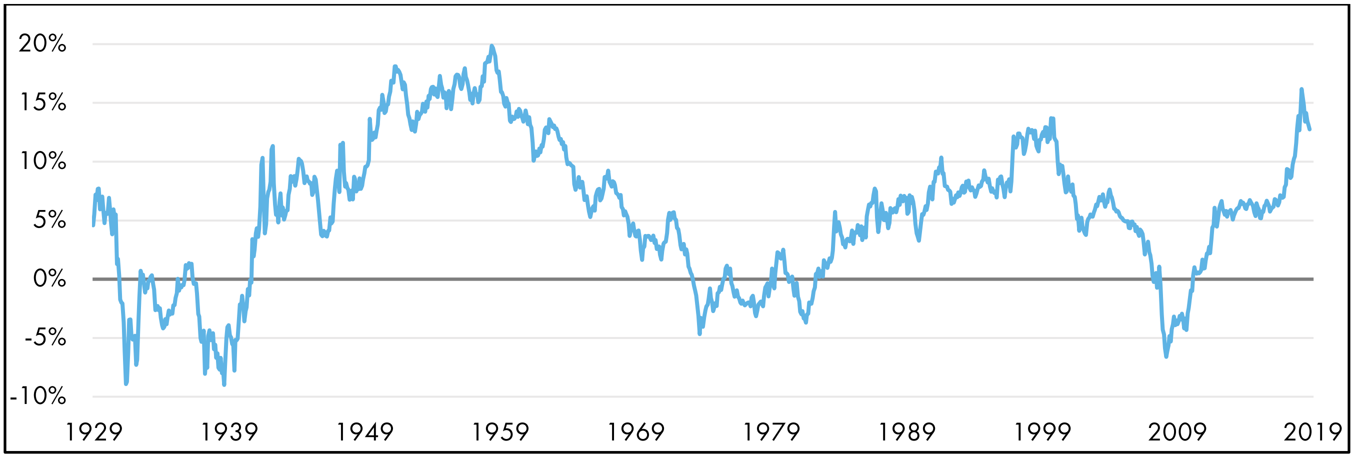
Viewing asset class returns through the framework of cash plus a risk premium is perfectly logical because every asset prices versus cash. For example, if cash is yielding 15% (like it was in the early 1980s), then no one would invest in stocks if its expected return was only 9%. Likewise, if the risk-free rate drops to 0% (as it did in 2009), the same 9% equity return would be far more appealing. Indeed, stock prices constantly adjust to cash rates (both current and expected future levels) in order to offer a reasonable return premium. Of course, cash rates don't wildly fluctuate so stock prices over the short-run are typically influenced by undulating economic conditions and shifting risk appetite. That said, as historical data has shown, longer-term returns are heavily dependent on the yield of cash.

The Past 10 Years

The general perception that US stocks offer very high returns has been reinforced by results over the past decade. In reality, the returns during this period have been unusually high relative to history. Chart 1 on the next page provides 10-year rolling returns of US stocks going back one hundred years. Excess returns above cash are used in the table for the reasons referenced above.

[1] Data source: Bloomberg from 12/31/1919 to 9/30/2019. Backfill methodology for US stocks: S&P 500 Index (SPX) from 12/31/1927 to 9/30/2019 and Dow Jones Industrial Average Index (DJI) from 12/31/1919 to 12/31/1927. Backfill methodology for cash/risk-free rate: 3 Month US Treasury Bills (G0O1) from 12/31/1925 to 9/30/2019 and 3-6 Month US Treasury Bills from 12/31/1919 to 12/31/1925.

Chart 1: Rolling 10-year excess returns of US Stocks[1]



Note that performance over the past 10 years was only surpassed during bounce-back years following the Great Depression, clearly suggesting that recent returns should not be extrapolated into the future. Table 1 breaks down excess returns by decade, further highlighting the aberration of the current period.[1]

Table 1: Excess returns of US Stocks by decade[1]

1920s	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s
5%	-4%	9%	17%	4%	0%	7%	12%	-4%	12%

■ > 10% ■ 1% - 9% ■ < 1%

The Next 10 Years

The factors that drove returns to historic highs are numerous: economic/market recovery from depression-like conditions during the 2008 financial crisis, the decline in interest rates from normal levels to zero, massive global quantitative easing, record high profit margins, low inflation, etc. These unprecedented tailwinds are unlikely to repeat over the next 10 years. Perhaps other positive forces will emerge (such as monetary and fiscal policy coordination), but it would not be reasonable or prudent to expect such an outcome.

Looking ahead at equity returns, cash is currently yielding about 2% and is discounted to decline further.[1] Even if US stocks were to deliver its 100-year historical average return of cash + 5%, the end result for investors could be quite underwhelming.

The prospective return of US stocks is important because most portfolios are concentrated in this market segment, and this material overweight has been further reinforced by the recent outperformance of the asset class. Consequently, investors have real potential to be disappointed with their total portfolio results over the next 10 years.

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For these reasons, we believe that enhanced diversification of portfolios may be the single most important investment decision for investors. The biggest issue we see with the traditional asset allocation is the overdependence on strong US equity market performance. In future *Insights* we will share our thoughts about diversification strategies that may potentially improve the odds of financial success over the next decade.

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