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MARKETS

The New Era of Low Stock Returns

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After more than six years of a bull market, investors should stare a cold, hard truth straight in the face: Future returns on stocks are likely to be far slimmer than the fat gains of the past few years.

Leading investment analysts think you will be lucky to squeeze out an average return of 2% annually, after inflation and fees, from a typical portfolio of stocks and bonds over the coming decade or so.

Investment expenses will loom much larger in a world of smaller expected returns. So will avoiding big mistakes.

The Dow Jones Industrial Average fell 2.7% from its Monday high to its close on Friday as economic growth seemed to falter. But that wasn't nearly enough to make stocks cheap.

One measure of valuation, based on data compiled by Yale University economist Robert Shiller, shows that the market price of the S&P 500 is about 27 times its average earnings over the past 10 years, adjusted for inflation. The long-term average, based on data going back to 1871, is about 16 times adjusted earnings.

So how have U.S. stocks performed in the past when valued around 27 times average earnings? Over the following 10 years, they generated total returns, counting dividends and adjusting for inflation, averaging about 2.5% annually, Prof. Shiller told me earlier this month.

Another method of estimating future stock returns yields a higher expectation—by a hair.

Over time, the return on stocks after inflation has tended to come very close to the sum of two numbers: dividend yield—total dividends over the past year divided by the current share price—plus the inflation-adjusted growth rate in dividends. The yield on the S&P 500 is 2%. For more than a century, the growth rate has averaged about 1.5% after inflation. Add those two numbers and you get 3.5%.

Now consider that the yield—interest income divided by price—on 10-year U.S. Treasury notes is 2% and that the government's core measure of inflation is running at about 1.7% annually.

If you have half your portfolio in stocks that return 3.5% and half in bonds that return 0.3%, you will earn about 1.9% after inflation. If stocks average the 2.5% return from Prof. Shiller's data, then a balanced portfolio will return only 1.4% after inflation. (These numbers assume no fees, taxes or trading costs.)

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Either way, "it's pretty awful by historical standards," says William Bernstein, an investment manager at Efficient Frontier Advisors in Eastford, Conn.

Before you despair, bear in mind that the 2.5% expected return that Prof. Shiller derives from his historical data is an average of many 10-year periods in which stock returns ranged from losses of nearly 5% to gains of about 7%. All these results are averaged annually including dividends and after inflation. So 2.5% is a general expectation, not an exact certainty.

Still, keeping your expectations low is a good idea. “The problem isn’t that you might be not able to get better than a 2% return,” Mr. Bernstein says, “but that even getting 2% isn’t going to be psychologically easy.” With stocks and bonds alike still near record prices, they remain vulnerable to the sort of shocking decline that can shake many investors out of their conviction.

A few clear guidelines can help you stay the course.

First, you aren’t entitled to higher returns just because you feel you need (or deserve) them. If traditional investments deliver paltry returns, that doesn’t ensure that “alternatives” like hedge funds, complex trading techniques or esoteric bond funds will do any better.

Take extra risk in a low-return world and you are likely to reap the risk without earning the reward.

“The things that feel most uncomfortable in the short run are generally the most rewarding in the long run,” Mr. Bernstein says, “and right now one of the most uncomfortable things is holding cash and fixed income.” By hanging onto your cash even at today’s invisible yields, you will be able to buy stock in the next downturn when shares finally become cheap again.

You can also look overseas now. “The expected returns on foreign stocks are higher,” Mr. Bernstein says, “plus you’re buying the currencies cheap relative to the dollar.”

Stocks in Europe and selected other international markets are one-half to one-third as costly as U.S. shares by Prof. Shiller’s measure.

Inching up your exposure to non-U.S. stocks through portfolios like the iShares Core MSCI Total International Stock exchange-traded fund or the Vanguard Total International Stock Index Fund makes good sense. The funds each charge annual expenses of 0.14%, or \$14 per \$10,000 invested.

Next, treat every nickel like a manhole cover.

Purge any expensive mutual funds, replacing them with well-diversified, low-cost index funds or ETFs. Against a backdrop of 2% returns, a half-percentage-point reduction in management fees will give a bigger boost to your returns than almost anything else you can do.

Finally, most financial advisers, when pressed, will concede that their fees are negotiable. Now, when a 1% annual fee eats half your expected rate of return, is an excellent time to haggle.

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