

## Great Expectations & Realistic Returns

*By Randy Zaharia*

In many of Charles Dickens' novels, the characters faced realistic situations that were grim and difficult, but ultimately, the positive power of human dignity, courage, compassion, and man's capacity for redemption and change resonated in the end. Loose parallels can be made between Dickens' novels and today's investors. Over the last two years, investors have faced a difficult environment where overall equity markets declined by -20% to -30%, a very grim reality. However, there are positives in the US economy and in the financial markets that should underpin continued growth over the balance of this decade, such as improving productivity and continuing technological advances. The question, then, is what are realistic investment returns? What should one expect? To help answer these questions, let's consider three perspectives:

- Historical return patterns
- Recent corporate behavior
- Theoretical basis

### **HISTORICAL RETURNS**

According to historical studies done by Ibbotson Associates, the average

annual large-company equity return from 1926 through 2001 was approximately 12.7%. However, that was not accomplished in a straight line (see Long-Term History of US Capital Markets chart on page 2). For the 75-year period from 1926 to 2001, about 20 years experienced negative returns. In other words, about one in four years were down for every three years that were up. In the last six decades of the 20<sup>th</sup> century (1940-1999, basically the post WWII time period), three decades averaged 18% to 21% annually and three decades averaged 7% to 10% annually (see Average Annual Returns by Decade chart on page 3). In the 1980s and the 1990s, annual equity returns were roughly 18% and 19%, respectively, and returns at the end of that period (1995-1999) were in excess of 20%. Both of these decades had return averages far above the 12.7% historical average. Alternatively, the 1960s and 1970s at around 9% and 8%, respectively, were significantly below the historic 12.7% average. Finally, the 1950s exceeded the average at over 20% annually, while in the 1940s, the average was only about 10%. Examining this pattern



### *Inside:*

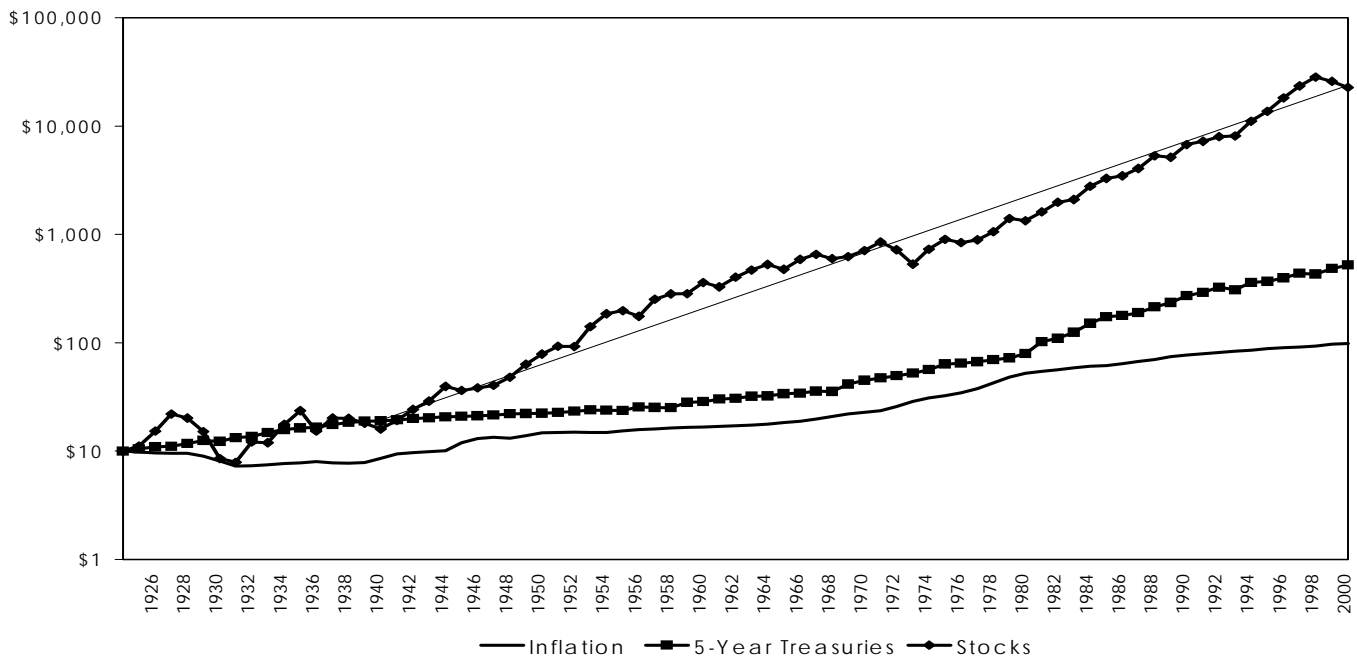
#### **Setting Standards**

By Bruce White

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## Long Term History of US Capital Markets 1926-2001



indicates there was a one to two decade alternating outcome with respect to the long-term average. If the pattern should continue, it would suggest that this decade would probably see equity returns in the 8% to 10% range.

### CORPORATE BEHAVIOR

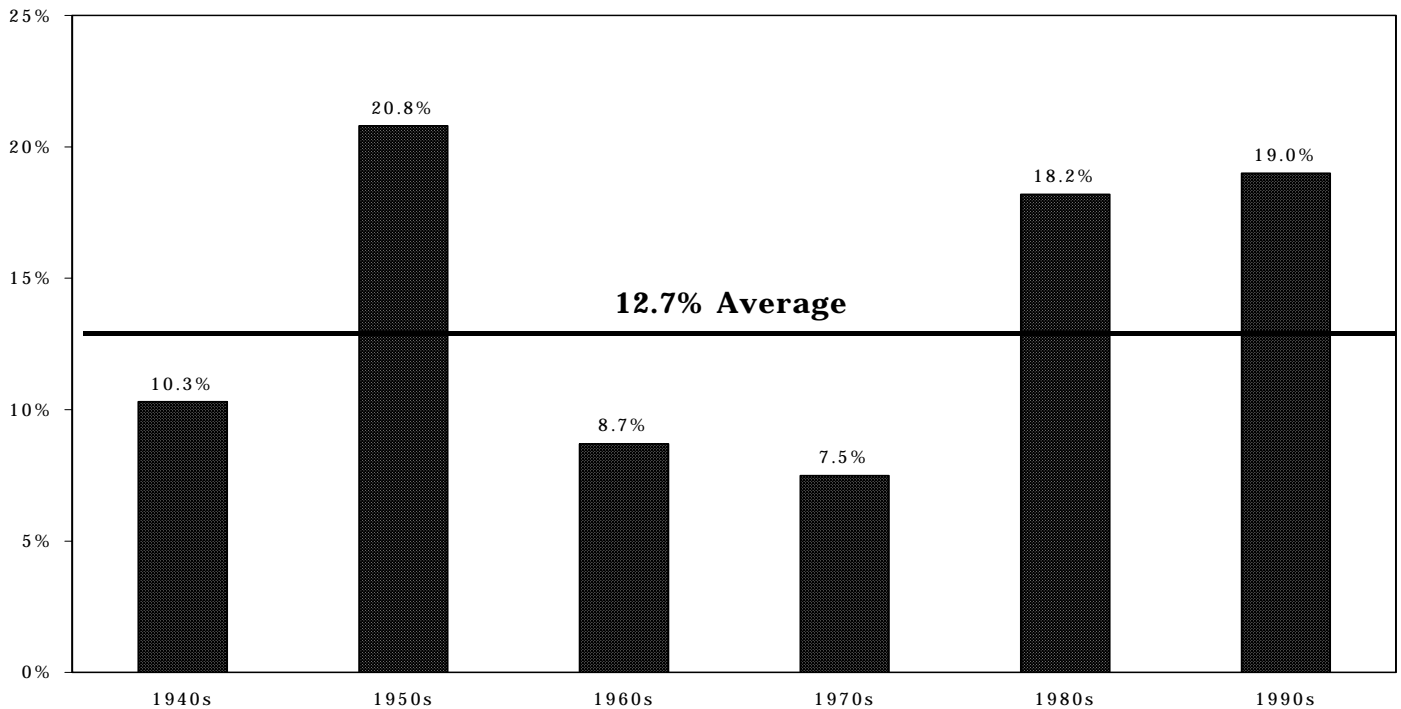
Corporations also appear to be adjusting their equity return expectations for their pension investments. Recently, General Electric (GE), one of the bluest of "Blue Chip" companies, lowered the investment return assumption in its multi-billion dollar pension plan from 9.25% to 8.25%, a significant move with billion dollar implications for GE's profits and expenses. Our analysis of this change, assuming bond and cash returns at historical averages, implied a decrease in GE's overall equity return assumption from roughly 12% overall to about 10% to 10.5%. This is a significant change in equity expectations and consistent with our analysis of historical return patterns as noted above. Given the sophistication

of a company like GE, it is very possible that they also considered the theoretical basis for expected returns in determining a new expectation.

### THEORETICAL BASIS

Let's also, then, consider the theoretical basis for expected returns. Recent Gross Domestic Product (GDP) and Consumer Price Index (CPI) reports, as well as the implied inflation rate embedded in inflation-adjusted Treasury bonds, suggest that inflation and expected inflation appear to be between 1.5% to 2.5% per year. Also, equity premiums (the return on equities over and above the inflation rate) have historically averaged around 8% to 9%. However, recent research suggests that wider ownership, increased portfolio diversification, and other factors may have permanently lowered that equity premium to the 6% to 8% range. Assuming inflation at 2% to 3% (a bit higher than implied), plus an equity premium of 6% to 8%, estimated equity returns for the entire decade should be roughly 8% to 11%.

## Average Annual Returns By Decade



Bond returns, with historical real premiums of 2% to 3%, should average 4% to 6%. Clearly, equity is still the superior return choice and should return twice that of bonds (approximately 10% equity vs. 5% for bonds) over the 2000s.

### REASONABLE EXPECTATIONS

Overall, given historical patterns, corporate behavior (GE), and theoretical constructs, there appears to us to be a reasonable expectation that stocks will provide returns in the high single digits to the low double-digits (8% to 11%) during the 2000s while bonds will continue to provide modest returns at around the 5% level. Further, given the -20% market decline since the end of 1999, returns for the balance of this decade may average at least 10% or higher annually. As a result, we believe that investing in attractive, high-quality companies with strong fundamentals and cash flows, purchased at reasonable valuation levels, should help us to build diversified portfolios of stocks that will achieve overall returns of 10% to 13% annually. In this environment, 11%

or 12% returns may look absolutely sterling. Reasonable expectations may lead to great "relative" returns.

On a final note, recent research has also shown that firm-specific volatility has increased steadily since the 1970s, especially with respect to companies that utilize or capitalize on new technologies. As a result, stock selection, more than ever, will be critical. In this context, Clifford's time-tested approach to the markets and focus on the long-term should do well. Our approach to reviewing companies considers several key characteristics:

- Superior management
- Strong financial situation
- Growth of cash flow, sales, and earnings
- Competitive position in a growing industry
- Reasonable and attractive valuations

And as always, a well-diversified portfolio reduces risk.



**Principals:**

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There has been much criticism of the accounting practices of public companies. We agree the Enron/Arthur Anderson problems highlight current deficiencies. This is not a sudden development. Since 1995, accounting irregularities have occurred at Bausch & Lomb, Rite Aid, Cendent, Sunbeam, Waste Management and Dollar General, to name a few. It has become increasingly difficult to digest financial reports. Many companies "manage" their earnings through complex accounting methods. Offshore limited partnerships, like Enron's, are the extreme. Executive stock options, derivative transactions, treatment of goodwill and changes in market value of held securities all distort the investor's view of corporate strength. Much of our analytical work is "cleaning up" the accounting to be used in our decision process.

Clifford Associates has had a long commitment to the Association for Investment Management and Research (AIMR). Thomas A. Bowman, CFA, President and CEO of AIMR recently outlined the organization's position. We agree with AIMR's call for:

1. Management to place the needs of owners of a company ahead of corporate interests by providing balance sheets that disclose all assets and liabilities under their control, show changes in the market value of company-owned securities with the resulting effect on earnings; to explain how and why they use derivative securities; to put stock option expense on the income statement, and refrain from managing earnings.
2. Corporation board members to be held responsible for full accounting disclosure.
3. Auditors not be allowed to conduct internal audits, internal reporting, consulting and structuring of corporate finance. Disclosure of any non-audit services provided by auditors.
4. Securities & Exchange Commission (SEC) to have adequate funding to effectively enforce current regulations.
5. Congress to allow the private sector to fix itself and protect the needs of investors first.
6. Investment analysts to be independent. (See Clifford's Summer 2001 newsletter "Unbiased Advice?") Too often, research is not objective but rather motivated by commissions and other profitable relationships with corporations.

Investors must act **as owners** and demand accurate reporting. Corporations attempt to give owners what they want, short-term results. They must press forward as owners who are looking for successful long-term corporate strategies and are demanding personal integrity at the board and management level. Regulators must set rules and dole out appropriate punishment for violators. In our view, desirable changes require action by both government and investors. Proxy voting allows us to have direct input on these issues.

