

THE REAL RISK IS TO NOT INVEST IN STOCKS

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Much has been written about the risks associated with investment in common stocks. Concern has centered on the wide swings in stock prices, which has led to broader diversification of institutional portfolios to reduce such risk. Theoretical risk-adjusted returns have been developed by modern portfolio theorists to determine if risk is being adequately rewarded.

Despite the concern regarding risk in the stock market, the rates of return from equities have exceeded the rates of return from both long- and short-term fixed-income investments over each of the periods shown in the below chart headed "Annual Rates of Return."

Annual Rates of Return*			
Period	S&P 500	Salomon Bros. Long Term Corp Bond Ind.	90-Day T-Bills
1930-1980	9.5%	3.4%	2.8%
1940-1980	11.5	2.7	3.4
1950-1980	10.9	2.8	4.4
1960-1980	8.3	3.3	5.5
1970-1980	8.5	4.2	6.8
1975-1980	14.0	2.2	7.9

*Figures represent updated work on Ibbotson and Sinquefeld's "Stocks, Bonds, Bills and Inflation" (footnote a/o 1982)

If most institutions such as corporations, state and local governments and unions are ongoing entities – which they are – and if their pension plans are ongoing too, it is interesting to note that the typical pension plan has been invested on average 50% in common stocks over the past 30 years. While fixed-income investments may be appropriate to take advantage of short-term swings in the capital markets on occasion, the commitment to equities by pension plans has been remarkably low given the higher rates of return available from common stocks versus fixed income investments for decades.

Admittedly, real estate has proven to be a worthwhile investment for pension plans during the past decade, with rates of return better than stocks or bonds. However, a study done by Carol Fall and Roger Ibbotson on various rates of return in the capital markets, including real estate, for the period 1947-1978 shows that stocks actually provided better returns than real estate over this longer time frame. This may come as a surprise to many investors.

To put further into perspective the returns associated with equities versus fixed income securities, a \$1 million investment in 1930 would have grown to nearly \$93 million in 1980, assuming the annual rates of return for the



Standard & Poor's Composite Index. By comparison, the same \$1 million invested in Salomon Brothers High Grade Corporate Bond Index would have grown to only \$5 million, and \$1 million invested in Treasury Bills would have grown to only \$4 million from 1930 to 1980.

Using the 1950 to 1980 period when stocks represented about half of pension fund assets, a \$1 million investment in the typical pension fund at the outset would be worth about \$7.3 million by 1980 while \$1 million invested solely in stocks would be worth about \$22 million by 1980.

Obviously, the funding requirements of such a pension plan would have been dramatically reduced over the years given a much higher exposure to common stocks.

Stocks are assumed to be a hedge against inflation, but little has been published on the reasoning behind this tenet. Why, then, are stocks a hedge against inflation? The answer is that there is a real growth factor of roughly 2% in corporate profits regardless of the level of inflation. Note in the below table "Annual Rates of Change" how corporations have adjusted to various levels of inflation in the past half century.

Annual Rates of Change		
Period	Consumer Price Index	S&P 500 Earnings
1930-1980	3.4%	5.8%
1940-1980	4.7	8.2
1950-1980	4.3	5.7
1960-1980	5.5	7.8
1970-1980	8.1	11.2
1975-1980	9.2	13.2

When inflation accelerates there may be a temporary lag in corporations adjusting to higher levels of inflation. A concomitant downturn in the business cycle usually restricts the ability of corporations to raise prices and protect profit margins. Uncertainty may prevail as to what the new level of inflation might be, so a lag could develop

in re-establishing appropriate pricing for products and services.

Even though the rates of inflation accelerated to an annualized 9.2% during 1975 to 1980, compared to an annualized norm of 3.4% during 1930 to 1980, corporate profits growth spurted to an annualized 13.2% during this five-year period, or more than double the annualized 5.8% rate experienced over the same fifty-year interval. This recent experience demonstrates the ability of corporations to adjust profitability to an acceleration in inflation.

When inflation accelerates, stocks tend to outperform bonds. With the rise in inflation during the 1970s, annualized rates of return were respectively 8.5% and 14.0% during 1970 to 1980 and 1975 to 1980 for the S&P 500 compared to annualized returns of 4.2% and 2.2% for Salomon Brothers Bond Index.

Many investors assume that in a period of declining interest rates more money will be made in bonds than stocks. This may be true in a given year or two, but not over any lengthy period of time. Let's look at the experience in the table headed "The Effect of Declining Interest Rates" by examining the three periods of the sharpest declines in interest rates from peak to trough during the past half-century, even though there is an overlap of periods.

The sharpest percentage drop in rates occurred during 1932 to 1946. The yield on Moody's AAA corporate bonds dropped by two-thirds, from 9.3% in 1932 to 3.1% in 1946. Over this 14-year span the annualized total returns were 11.5% for stocks and 5.3% for bonds. It may come as a surprise that stocks outperformed bonds even during periods of substantial declines in interest rates.

Some investors view market timing as the answer to achieving superior rates of return by moving from stocks to bonds to cash, back to stocks again, and so on. During the 1960s and early 1970s, the stock market correctly anticipated six consecutive times by three to eight quarters

the turn in the economy, as measured by profits of Standard & Poor's Industrial Index. Starting in 1974, the discounting mechanism of the stock market, as measured by the S&P 500 index, has not led to the turn in profits in the last three tests.

Inflation had distorted our entire economic system. The classical economic cycle of two-and-one-half years of economic expansion followed by 10 months of recession seemingly no longer prevails. During the past three years the economy has contracted in the second quarter of 1979, 1980 and 1981. In 1980, the economy went into the shortest recession since World War II, lasting from January to July. The bond market offers unprecedented real yields. And the stock market no longer discounts economic events in the classical way.

How does one expect to market time under these circumstances? One major pension fund survey indicates that of approximately 600 professed market timers, less than half a dozen have demonstrated a good track record as market timers during the past decade.

Another pension fund survey indicates that less than 10% of the funds in its survey have added value by market timing over the past five years. Given topsy-turvy economic events and failures of market timers in recent years, it appears that

successful market timing is a very elusive goal at best.

Since institutional pension plans are so long-term in nature, the risk in common stocks is not in the fluctuations of the

stock market. The biggest risk lies in lack of greater exposure for prolonged periods. Historically, stocks have generated the highest returns. If most institutional pension plans are ongoing entities, it seems entirely appropriate that pension plans have a higher long-term exposure to stocks than the approximate 50% level of the past several decades. Based on more than half a century of accumulated evidence, pension plans willing to make a higher commitment to the stock market will be rewarded with superior rates of return in the future.

The Effects of Declining Interest Rates				
Period	Yield decline in Moody's AAA Corporates	Change in yield	S&P 500 (annualized)	Salomon Bros. Corp. Bond Index (annualized)
1930-1950	4.6% to 2.5%	(46)%	7.4%	4.5%
1932-1946	9.3% to 3.1%	(67)%	11.5	5.3
1938-1950	5.8% to 3.2%	(45)%	10.1	2.8

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