

Chapter 11

Solutions & Expectations

We should never trust an answer less simple than the one that will do the job perfectly well.

William of Ockham

In Part I of this book, we discovered that a huge performance gap exists between financial market returns and individual investors in the markets. We found several reasons for the performance gap including high costs, market-timing, and chasing hot investments. Part II examined the pitfalls of following the recommendations of investment “experts” and others who thrive on investor mistakes. The financial industry presents ideas to the public in a manner that makes people believe they can beat the markets, which does more harm than good.

Part III is about closing the performance gap. We will learn how to achieve a fair return on your money without taking undue risks. By avoiding high fees and poor behavior, you can enjoy the fruits of the market place.

There is a second lesson to learn in Part III. Taxes are a hidden burden on returns. The power of tax efficiency can significantly increase your wealth over the years.

What You Can Reasonably Expect

The last fifteen years have spoiled us. The stock and bond markets have returned unprecedented gains during the 1980s and 1990s. Many investors believe the bull market will continue for many years into the future. A 1999 survey of investors conducted by *Paine Webber* found that the typical investor believes the stock market will achieve annual returns over 15% for the next ten years¹. Obviously, most investors have not experienced a prolonged bear market, but that does not mean one will not occur in the

future. Before jumping into specifics about investing in the markets, a review of past returns and future expectations is warranted.

Contrary to recent history, there have been long periods of time when the stock and bond markets have not been great investments. From 1968 through 1982, the stock market returned only 6.3%, and long-term government bonds 2.9%. More important, inflation was 7.3% during the same period, meaning that real return for stocks and bonds was negative. It was a terrible 15 years for owners of financial assets. Contrast that with the 1984 through 1998 period. Stocks returned 17.9% and government bonds 12.2% at a time when inflation was only 3.3%, meaning the markets generated unprecedented high real gains.

A long bull-bear market cycle seems to take about 30 years to complete. Basically, every generation has had a bull market and a bear market. Two times in the 20th century there were wide swings in value of financial assets. The baby boomers have not seen a bear market. No one knows when the down cycle will come or what will cause it, but one is very likely to occur in the next twenty years.

Inflation Adjusted Real Returns

We invest in stocks because over long-term periods of time, stocks perform better than bonds and money funds. But what can we expect in the future? That question cannot be answered by only looking only at past returns because inflation distorts the numbers. If an investment generated a nominal return of 5% and at the same time inflation was 5%, the *real* return was 0%, before paying taxes on full 5% gain.

The best way to state the returns of stocks and bonds is as a percentage over the inflation rate. Since 1926, large US stocks returned about 8% over inflation and bonds returned about 3% over inflation. Treasury bills average less than 1% over inflation². Due to the recent strength in the US economy, the valuation of the stock market is well over its historic norm. As a result, investors should plan on inflation-adjusted return for stocks of no more than 6% over the next few decades.

¹ PaineWebber's Index of Investor Optimism, *Business Investors Daily*, April 28, 1999, pg. b1

² Ibbotson Associates, *Stocks, Bonds, Bill and Inflation, 1999 Yearbook*, Chicago, Illinois

If we apply these long-term expectations to today's inflation rate of 2%, it leads me to believe that large US stocks might return about 8 % over the next 30 years and bonds might return about 5%. An 8% expected return from stocks is much lower than the 15% return investors expect according to the *Paine Webber* survey. But this number is more realistic because it is based on the potential growth of earnings, not the inflation of market valuations.

Table 1
**Historical Returns and Future Estimates of
 Stocks, Bonds, and Inflation**

	1926-1998	<i>Estimate 1999-2030</i>
Inflation Rate	3%	2%
Bond Returns (nominal)	6%	5%
Bonds – Inflation adjusted	3%	3%
Stock Returns (nominal)	11%	8%
Stocks – Inflation adjusted	8%	6%

The figures above are market returns before commissions, fees, and income tax. Investors should not confuse these market expectations with the returns an individual investors will achieve. It is very likely the returns of the average investor will be much lower than the market due to the reasons stated in Parts I and II of this book. Astute investors know that in the long-term, it is very important to keep fees low and reduce taxable income.

My estimates of future market returns are also less than what the sellers of investment products like to infer. Many advisors will quote an expected return on stocks of 11% or higher, because that is its true historic number. But this logic is flawed. It does not take into consideration the historic inflation rate of 3.1%, or the expanded valuations of stock prices. Expectations of return should move *lower* as the markets move higher and inflation subsides. Much of the bull market in stocks and bonds during the last two decades was a direct result of inflation falling from 13% in 1980 to less than 2% in 1999. That will not happen again. Interest rates will not go below 0%.

Why do stock valuations go up as inflation falls? Assets that produce annual income are worth more when inflation drops because the cash goes a lot further when buying things. This also means corporations with earnings growth are worth much more in a low inflation environment because that growth is real. The more an investor pays for

expected earnings growth, the lower their total return will be going forward. Expected earnings growth does not change with a change in the inflation rate, but the amount that people will pay for that growth does change. A corporate earnings stream can be compared to bond interest. Bonds pay a certain interest rate each year, but the total return you get from the bond is based on the price you pay for that income stream. The more you pay for the right to the known stream of interest payments, the lower your yield to maturity on the bond. The same mechanisms are at work in the stock market. The more you pay for future earnings growth, the lower your total return on stocks in the future.

There is another reason to embrace a conservative stance for expected stock and bond returns. As part of your retirement savings strategy, you should create an investment plan (Chapter 14). The plan will require that you make an estimate of your investment return over the years. It is far wiser to use a conservative estimate of return and be pleasantly surprised if the market performs well than to use a high number and watch the market perform poorly. In the second scenario, you may not accumulate enough money to retire.

Overview of the Chapters in Part III

Chapter 12: Investing in the Stock Market

Almost every financial plan will lead to some investment in the stock market. What is the best way to achieve a fair return in stocks? The answer is to develop a diversified portfolio of low cost, market matching index mutual funds.

Indexing the stock market makes a lot of sense for four reasons. First, they are low cost. Second, index funds perform better than almost all “active” mutual funds due to the lower cost. Third, they reduce the desire to chase the hot dot since investors already own all stocks. Fourth, index funds are very tax efficient.

Nearly every academic study concludes that index funds offer better performance overall than active strategies. A few actively managed funds are able to achieve returns that are higher than index funds, but it is impossible to tell which funds will be successful in the future.

Chapter 13: Investing in the Bond Market

This chapter gives the reader insight into fixed income investing, and outlines two strategies to keep costs low. One strategy calls for investing in high quality, individual short-term bonds, which avoids the expense of investing in a mutual fund.

Generally, a self-managed bond portfolio generates a higher return than a fund, especially in area of tax-free bonds. Individual bonds can be purchased from a variety of sources. You may purchase Treasury bonds directly from the government or through any stockbroker. The concept of developing and maintaining a bond “ladder” is also discussed.

The second strategy discusses bond index funds, and building a portfolio based on bond index funds. When considering high-yield bonds and other complex fixed income assets, I recommend using mutual funds instead of individual bonds.

Chapter 14 - Financial Goals and Asset Allocation

It is very important to plan a retirement savings strategy before selecting your investments. When setting financial goals, you must determine how much income you will need at retirement and what amount of income will come from personal savings. This information will determine the size of the nest egg you need to accumulate. Once you know this amount, the next step is to develop a plan for accumulating those assets.

The theory of asset allocation is discussed in Chapter 14. Asset allocation helps investors achieve a fair rate of return on their investment while reducing risk through broad diversification. If practiced effectively, asset allocation helps eliminate most of the performance gap caused by market timing errors.

Chapter 15: Tax Efficient Investing

Uncle Sam wants you to pay income taxes, but you do not have to pay him right away. In fact, you can legally delay most income taxes on investment gain indefinitely, even after death. The longer you delay paying income taxes, the more money you will accumulate. A good investment plan always puts heavy emphasis tax efficient investing. Chapter 15 links successful tax strategies with wealth accumulation.

Inflation is also a form of taxation, which is brought about by our government's fiscal and monetary policies. Since we are not in a position to change the inflation rate, we must build portfolios that adjust our retirement income for anticipated inflation.

Chapter 16: Putting it All Together

This chapter summarizes the concepts in this book by presenting a case study. A middle-aged couple has been very successful in their chosen occupations, but not very successful investing the proceeds of their labor. The case focuses on common misconceptions discussed in this book, and offers several changes to help the couple close the performance gap in their portfolio. Although you may see similarities with your own situation, this is only an example and is not intended to be a model for the masses. Each case is unique.

Summary

Investing for retirement can be simple, profitable, and tax efficient. By ignoring Wall Street hype and investing in a sound portfolio of market matching investments, you will have a greater likelihood of achieving long-term success. It is the markets that make us wealthy, not complex strategies designed to beat them.