The Cult of Equity

Viewing the panorama of long-run stock returns

In 2012, PIMCO founder William Gross asserted that the cult of equity is dying because of the prospect that US stocks would deliver a significantly lower real return than the 6.5%pa (with dividends reinvested) that the past century had produced.

Mr Gross's argument is straightforward. Real GDP has expanded at an annual rate of 3.5% over the past century. Shareholders have skimmed an additional 3% pa at the expense of other stakeholders, notably labour, lenders and governments, which has boosted growth in earnings per share (EPS). The additional bonanza has accrued to shareholders due a lower tax take from governments and a decline in the labour or wage share of GDP since the early 1970s, from 50% of GDP to below 45%.

According to Mr Gross, the high growth in EPS is unlikely to be replicated, and consequently stocks will offer a nominal return (with dividends reinvested) of 4%pa going forward, a far cry from the return achieved over the past century. Mr Gross's argument of lower expected stock returns stemming from a reduction in future EPS growth is persuasive. But he doesn't provide a rationale for why investors should specifically expect stock returns of 4% pa.

Estimating expected future stock returns

Drawing on the work of Eugene Fama and Ken French, expected returns can be estimated from past stock returns or from fundamentals, notably dividends or earnings. The average stock return is equal to the average dividend yield plus the average rate of capital gain. Under certain conditions, compound annual growth in dividends (Dividend Growth Model) or earnings (Earnings Growth Model) can be used to approximate the average rate of capital gain.

Rather than focus on the past 100 years only, I utilise Robert Shiller's dataset of returns and fundamentals for the S&P500 that stretches back to 1871. US stocks have yielded a nominal annual return of above 8.5% over the past 140 years (dividends reinvested), with the average dividend yield contributing 4.4% and the average rate of capital gain accounting for the remaining 4.3%. The inflation adjusted return of 6.6% over this period is similar to Mr Gross's estimate over the past 100 years.

An estimate of future expected returns from US stocks requires estimates of the average dividend yield and the average rate of capital gain. Suppose that the current dividend yield of 2% represents an accurate estimate for the future average yield.

We are than left with three alternative estimates of the rate of future nominal capital gain: the average realised rate of capital gain (4.3% pa), historical average dividend growth (3.5% pa) and historical average earnings growth (3.9% pa). The three models yield the following expected nominal return estimates: 6.25% (Capital Growth Model), 5.5% (Dividend Growth Model) and 5.9% (Earnings Growth Model).

The mean nominal expected return from the three models is a little below 6%, well above Mr Gross's estimate of 4%. Assuming the average inflation rate of 2.1% over the past 140 years persists, this produces an average expected real return estimate 3.8%, lower than the average 6.5% real return that stocks has delivered since 1871 but higher than the expected returns from other asset classes and well above the 2% real return for stocks implied in Mr Gross's missive.

Mr Gross argues that lower EPS growth is the basis of lower future expected stock returns. But even the Dividend Growth Model produces an expected real return of 3.5%, still well above Mr Gross's estimate. This is important, because dividends have grown more slowly than earnings due in part to the increased propensity from the 1970s for US corporations to return capital to shareholders via buybacks.

Good news, bad news

The view that stocks will deliver lower expected returns than the past rests heavily on the assumption that the current dividend yield of 2% is a good approximation for the future average yield. Using the average yield of 4.4% since 1871 bumps up the average expected nominal return estimate across the three models to 8.3%. A difference in the expected annual return estimate of 200 basis points compounded over many years can make an awfully big difference to an investor's terminal wealth.

On face value, this represents good news for long-run investors and US corporate pension plans; higher discount rates reduce the present value of pension liabilities. But the good news comes with a sting; controlling for dividends, the market needs to halve from current levels to reach a dividend yield of 4.4%.

The past decade has been a timely reminder to investors that stocks represent a risky asset class. Shareholders after all, are the residual claimants to a firm's cash flows. University of Chicago professor, John Cochrane, argues that stocks represent the antithesis of insurance, offering a poor payoff when an individual's marginal utility of wealth or consumption is high. Stocks fall sharply in distressed states of the world, when the value of an investor's real assets are declining, notably their home and the present value of their human capital.

Just when an investor needs diversification benefits from her portfolio of financial assets to offset the declining value of her real assets, the value of stocks decline. Stock investors expect to be compensated for taking on this risk. Despite US Treasuries yielding higher returns than US stocks over the past decade, stocks should command a premium over risk free assets in the long-run.

Financial crisis babies

There are good reasons why investors over the next decade will expect higher stock returns than investors have expected over the past three. Behavioural finance research shows that investors who live through a bear market in their 20s, are more risk averse and devote less of their wealth to stocks over the course of their lifetimes than investors who experienced strong stock market returns during their formative years.

Similarly, another study shows that companies managed by CEOs who grew up during the Great Depression had lower gearing than other companies, controlling for other characteristics that affect a company's capital structure. Thus, as the current cohort of young people move into the wealth accumulation part of their lifecycle, these 'financial crisis babies' are likely to have a lower average allocation to stocks and expect higher returns from this asset class than their older cohorts.

If the current dividend yield holds, a period of lower expected stock returns awaits. Investors can expect stocks to produce a nominal return of around 6% (with dividends reinvested) and a real return of around 4% over the long-run, well below the 6.6% real return achieved since 1871 and a far cry from the real return of above 8% achieved over the past thirty years.

For those who believe that mid-single digit returns do not adequately compensate investors for taking on stock risk, a rise in expected returns requires either a significant correction to current stock prices or a prolonged period of stagnation in the market and a re-acceleration of dividend growth. While either of these scenarios might hasten the death of the cult of equity, they will also sow the seeds of its future resurrection.

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Charts underpinning the analysis and references cited are available on request.

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