Stocks - the most undervalued asset class

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$793,167 - that is the level the line for U.S. stocks on the chart below would have been at on Dec. 31, 2008 if stocks were valued at their historical average. Since the level is only at $480,873 you can see that stocks would need to rise 65% after inflation to regain the average level of the last two centuries. Don't think it could happen? Think again!

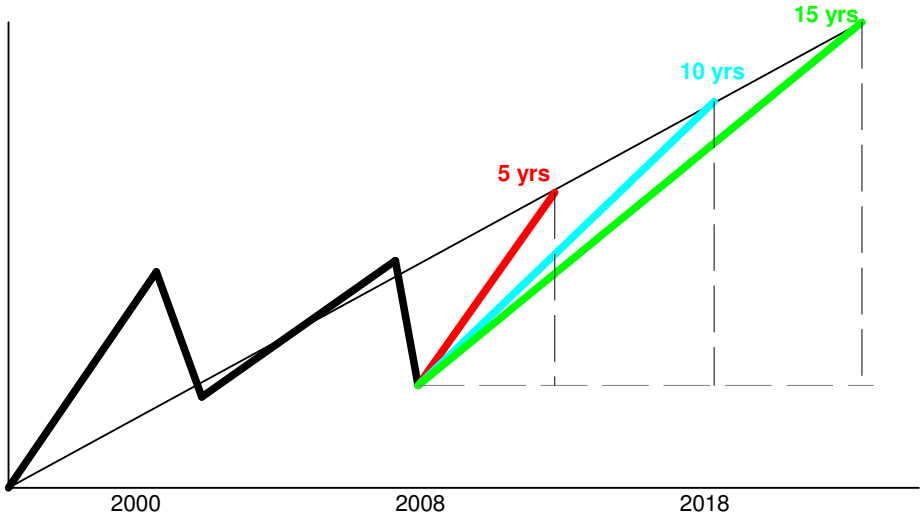
Chart 2 at the end of this commentary shows the value of $1 invested in the major U.S. asset classes from 1802-2008. Proportions are similar for Canada and other developed countries but the U.S. has a more developed historical record as explained in Prof. Jeremy Siegel's book "Stocks For The Long Run". All values are adjusted to remove the illusory gains of inflation and so this is called a REAL return chart instead of a nominal return chart. In summary, it shows that currency/cash has been devalued by 94%, gold has preserved value, fixed income has made modest gains (but mostly before the 1930's) while stocks have followed a steady march upwards. Stocks, steady? Yes, when we look at history we see that stocks, since they represent claims on the real assets and real income of the great businesses of the world, have naturally protected wealth from inflation and grown at the rate of human productivity gains. In fact, the slope of the straight line running through the stock data is called a regression line and stocks have always returned to this trend line - always. Not 70%, 80% or even 90% of the time but 100% of the time - no exceptions.

The last decade has been a gut wrenching one for owners of the great companies of the world. In the late 1990's we saw the line for stocks rise well above the long term trend line in what is now called the technology bubble. With the benefit of this hindsight we can now see that the climb of the 1990's was not sustainable and that stocks would return to their average valuation eventually. It turned out this happened very fast in 2000-2002 when we saw a 50% decline. At the bottom of the tech crash stocks were slightly under their long-term average level. From 2003-2006 they roughly followed the trend line and then in 2007-2008 they fell about 50%, to a level rarely seen in history, almost 50% below their long-term average. On December 31, 2008 the trend line was at $793,167 so stocks would have to reach this level simply to be at fair value. Of course, no one thinks this will happen in a month or a year, but what would the gains be like if it took 5, 10 or even 15 years?

There are two components in the calculation of the return to the trend line. The two components create a triangle (a vector for you mathematicians). This is illustrated in Figure 1 below. First, recall that the line marches forward at 7% per year after inflation and this provides a horizontal component. In 5 years the gain would be 40% after inflation, in ten years 97% and 15 years 176%. If we assume inflation will be only 2% then the nominal (raw) gains would be 54%,

137% and 264%. Second, there is the vertical component - the catch-up necessary to get back to the trend line. Stocks need to rise 65% to accomplish this.

Figure 1. A graphical illustration of how stocks might revert to their long term trend line over 5, 10 or 15 years.



When we compound the two types of return together we find that if it takes 10 years for stocks to return to the trend line the nominal gain will be 291% and average annual return 14.6%. If it takes five years the gain will be 154% or 20.5% per year and if it takes 15 years the gain will be 501% or 12.7% per year. All three of these are significantly better than the long term average, which is itself excellent.

Table 1. Expected gains over time using average returns

	Gains along trend line		Catch-up	Total	Total	Compound
Years	Real return	Nominal return	gain (vertical)	real return	nominal return	annual return
5	40%	54%	65%	131%	154%	20.5%
10	97%	137%	65%	225%	291%	14.6%
15	176%	264%	65%	355%	501%	12.7%

Actual real return 1802-2008	7%
Assumed inflation rate	2%
Assumed nominal return	9%

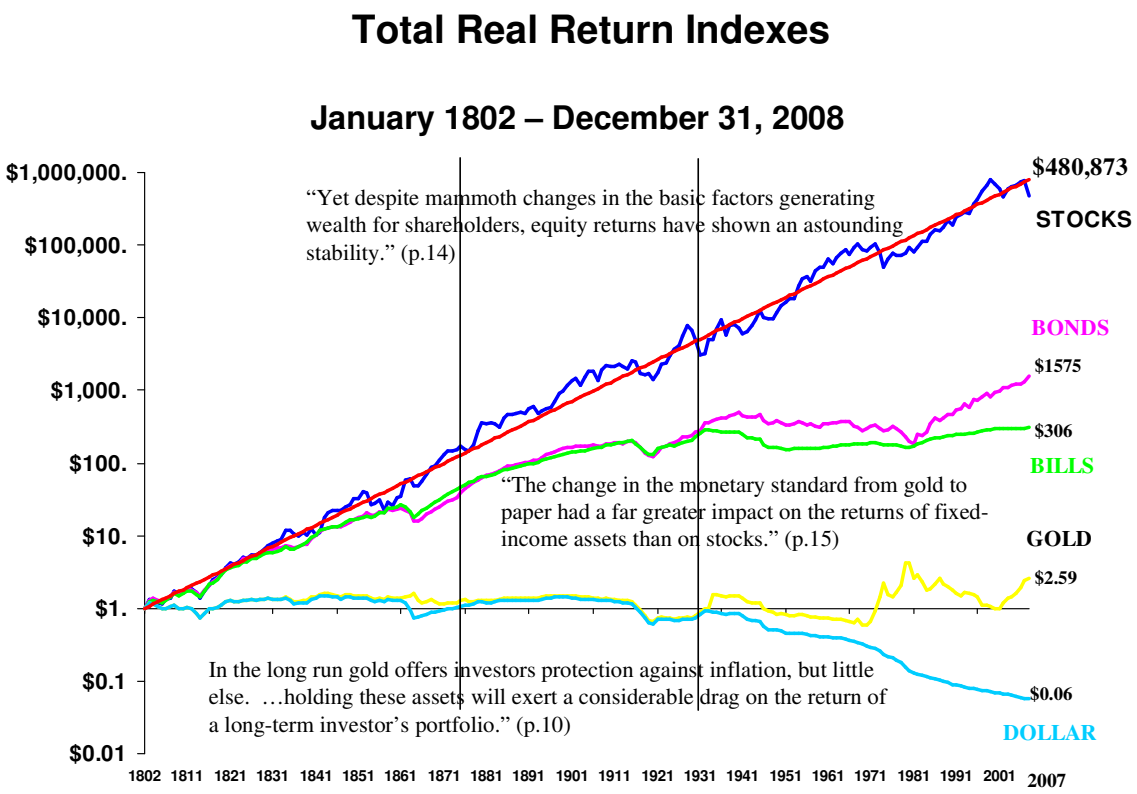
In contrast to all of these possibilities, many investors are currently running to and hiding in the apparent "safety" of government bonds and GICs. A ten-year government of Canada bond pays about 3% these days, so if a dollar is switched from stocks to bonds at this time then it will gain 34% over the next ten years. At that rate it would take 17 years just to increase 65% and regain the recent drop in stocks - not a sensible strategy for the great majority of investors.

As clearly shown in figure 2 and as I have written about elsewhere, stocks are definitely the only asset class that is capable of and has protected and grown wealth in the long run. This is because

stocks represent shares in the most crucial assets of society - the great companies where people work, produce value and are able to exchange it with others in return for a money income. In contrast, bonds and other fixed income instruments represent the debts of society and mostly produce returns measured in nominal dollars instead of real dollars. At times like these when stocks have been very high and now very low in a relatively short time (less than 10 years), many investors are tempted to think "this time is different" and that stocks represent a poor investment to be avoided.

In reality, the exact opposite is true and stocks are at a bargain level seen only a few times in history. Looking at the line for stocks in Figure 2 we can see stocks have been this low only after the oil crisis of the 1970's, during the depression of the 1930's, during World War I and the 1850's. I don't know if it will take 5, 10 or even 15 years or more for stocks to return to their long-term trend line. I just know they will and that the rate of return obtained during the move back to average will be both excellent and far better than the alternative of bonds, treasury bills, gold or cash. ***More than ever, stocks really are the best investment for the long run.***

Figure 2. Total real return indexes 1802-1998



Source: Siegel, Jeremy, *Stocks for the Long Run* (2008).