



Three Myths of Market Underperformance

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February 10, 2009

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The human propensity to gravitate towards evidence supporting existing biases is one of the most important lessons of behavioral finance.

What that means, quite simply, is that in buoyant markets, investors are prone to believe outrageous claims by market bulls – think no further than “the world has changed forever” rhetoric and best selling books like “*Dow Jones 36,000*” and Harry Dent’s “*The Great Boom Ahead*,” during the technology bubble of the last decade.

In the same way, in negative markets such as we’re experiencing right now, investors tend to believe even the gloomiest assertions from “media gurus” and self appointed experts. A recent New York Times article headlined “Forecasters race to call the bottom to the market” discussed the competition among market pundits to come up with the direst possible predictions.

Jumping on this bandwagon is the same Harry Dent, who just published “*The Great Depression Ahead*.”

Most members of the media strive for accuracy in their reporting and work very hard to get the facts right. Unfortunately, many of the assertions getting the highest profile are based on flawed analysis of past stock market performance. Pundits who distort history to get media coverage for their alarmist claims and well-meaning commentators who quite simply get the facts wrong are usually the culprits.

The only way for advisors to combat this misinformation is by presenting the true facts.



Among the common misleading claims about investing in the stock market recently espoused in the media are the following:

1. Investors made no money in the market from the mid 60s to early 80s.
2. It took 25 years for the market to recover to the level reached in 1929.
3. When inflation is taken into account, investors lost money for long periods of time.

Dealing with these claims requires advisors to beef up their arsenal of knowledge of historical performance and add resources with detailed data to their library. Here's some ammunition to get you started.

Stocks made no money from 1965 to 1982

A recent Newsweek cover article claimed that the stock market was no higher in 1982 (the Dow ended 1981 at 875) than in 1965 (when it ended at 969). When people make the case that the market can go sideways for long periods, this fact – and others like it – are their evidence.

On the face of it, it's hard to argue with this assertion ... unless we remember two critical points.

First, despite its prominence, the Dow Jones is only vaguely representative of the stock market as a whole. Because it only contains 30 stocks and is price-weighted rather than capitalization-weighted (i.e., a stock trading at \$50 has five times the weight of a stock trading at \$10, regardless of their market capitalization), it doesn't truly represent overall market performance. In the 70's in particular, the Dow Jones was laden with large household names referred to as "the nifty 50" that were chronic underperformers of the market as a whole.

Second – and more importantly – the overall price performance of this index ignores dividends, something that historically accounts for 40% of returns

From 1965 to 1982 the S&P 500, including dividends, had much better results:

Cumulative gain from Dec 31 1965 to Dec 31 1981:

Capital appreciation:	33%
Total return with dividends:	152%



The result is an annual return of 6% - well below the long run return on large U.S. stocks of 10% but still a very different proposition than being down over this period.

As an aside, people who use the period from the end of 1965 to 1981 are cherry picking one of the worst possible periods to make their case. Here's the total return for two 16-year periods, starting one year earlier and one year later:

Dec 31 1964 to Dec 31 1980:	198%
Dec 31 1966 to Dec 31 1982:	240%

Focusing on just the price performance of an index and excluding dividends isn't limited to the media – it's a trap that many investment industry analysts and financial advisors fall into as well.

Advisors looking for this information can find it in the Ibbotson yearbook, available for purchase on Morningstar's website. It contains all the historical data you could want and makes for fascinating reading – a great value at \$150 for advisors committed to professional advice.

Stocks took 25 years to recover to 1929 levels

A second common myth relates to how long it took for stocks to recover after the great crash.

Once again, if we look at just the price index, this is true. Looking at year-end price levels, it took until 1952 to match the high hit by the S & P index at the end of 1928, a disastrous experience for investors who held on through the great crash!

However, if we include dividends, we see a different story: at the end of 1952, the S & P was four and a half times the level of 1928, for an annual return of over 6% and a real return (after inflation) of 4% per year.

To counter arguments that distort reality, you need to have the real facts at your command.

Stocks lose money after inflation

Let's look a final example of fun with numbers.

A recent newspaper cover story featured an interview with Edward Kerschner, chief strategist with Citi Global Wealth Management, stating that in real terms the Dow fell 47% from 1960 to 1980. Kerschner's point was that markets can be



horrible places for long periods of time (especially with free spending presidents such as Kennedy, Johnson, Nixon – and perhaps Obama.)

Here are the year end numbers for the Dow, both before and after inflation:

Dec 31	Year end Dow Jones index	Adjusted for inflation
1959	679	679
1979	899	344

Again, it's tough to argue that this 20 period was good for investors in real terms – until we look at a broader based measure of stock market performance and include dividends.

S&P 500 from Dec 31 1959 to 1979	Gain	Real return adjusted for inflation
Capital gain	80%	(31%)
Total return	275%	43%

On a total return basis, the annual real return in this 20 year period was 2% - because of a combination of lower stock market returns and much higher inflation than the historical norms. This period did indeed substantially underperform the historical real return of 7% (a gain of 10% less 3% inflation). Still, underperforming with a real return of 2% is a very different story than losing almost half your money.

And again, on the theme of cherry picking time periods, if we use the 20 year period starting one year later, from the end of 1960 to the end of 1980, cumulative real returns were 71%, more than 50% higher.

None of this is intended to say that stocks will always be a safe or pleasant haven for investors. Despite the overwhelmingly positive returns long term investors in U.S. stocks have enjoyed across virtually every time frame, there is always the possibility that it could be different going forward.

Just remember, though, the only guide we have going forward is what happened in the past. And in looking at the past, we need to look at all the facts – not just those selected by people looking to grab newspaper headlines.



There are three key takeaways for advisors from this analysis:

1. It's fine to express doubt to clients about negative claims in the media, but being skeptical isn't enough unless you're able to provide hard data to offset suspected misinformation.
2. Don't fall into the trap of using narrow indexes and excluding dividends. The only thing that matters to investors is total return – and that's the only thing you should talk about. Remember, whenever clients or industry analysts talk about the Dow Jones or the S&P, they almost always exclude dividends.
3. Unless you have a solid knowledge of the facts, you will be unable to combat some of the distortions your clients will see in the media. Invest the time to ramp up your understanding of history to be a better resource to clients.

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