

# “THE DEATH OF EQUITIES”

“The Death of Equities” was the Business

Week cover story from 1979, suggesting that

stocks as an asset class would be a poor place

to invest for many years to come.

As we all know, the timing of that article could not have been worse, as the market embarked on a nearly 20-year bull market beginning in the early 1980s. We are now hearing a lot of the same comments about stocks today that were common in the early 1980s. Deficits are sky high, confidence is low at both the consumer and business levels, and the market has lost over 50% of its value since its peak in 2007 to its recent trough in 2009. So why would anyone want to own stocks given the current economic backdrop?

In this newsletter, we do not attempt to predict where the stock market will be in three months or even 12 months, but rather present data that will

hopefully provide some insight into whether you, as an investor, should have a portion of your investable assets in the stock market.

Most stock investors know that over time, stocks have generally outperformed other asset classes – particularly fixed-income alternatives – as the table on the next page illustrates. However, the compounding effect that long-term investors experience is very apparent when comparing cumulative values. For example, the difference between earning 9.6% in stocks versus 5.9% in corporate bonds since 1926 is an astounding 1,930 percentage points. Since few investors have an 83 year investment time horizon, this example is somewhat theoretical in nature; however, even if we shorten the timeline to 20 years, the 9.6% return stocks provide would still result in nearly twice the value of long term corporate bonds.

The price we pay as investors for this higher expected return is illustrated in the last column of the table labeled Average Annual Standard Deviation.

Asset allocation (the mix between stocks and bonds) will have the most impact on the performance of the portfolio, rather than the individual stocks or bonds we buy.



This is a measure of volatility, or risk, in owning the given asset class. As illustrated, owning stocks is nearly 2.5 times more risky than owning long term

confidence and probability of a positive outcome. One is by lengthening the investment time horizon, and the other is through asset allocation – or more

**SUMMARY OF RETURNS (1926 – 2008)**

	Average Compound Annual Return	Cumulative Index Value *	Average Annual Standard Deviation (Risk) **
Common Stocks	9.6%	2,045	20.6
Long Term Corporate Bonds	5.9%	115	8.4
Long Term Gov't. Bonds	5.7%	99	9.4
Treasury Bills	3.7%	21	3.1
Inflation	3.0%	12	4.2

Source: Wachovia Securities, 2009 Newsletter, "Why Invest in Stocks."

\* Cumulative index value reflects the value at the end of 2008 of \$1 invested at the beginning of 1926, earning the respective average compound annual return for each asset class outlined in the above table.

\*\* Average annual standard deviation is a statistical measure of risk or volatility of returns. For example, one standard deviation predicts a range of returns with 67% probability, whereas two standard deviations predict a range of returns with 95% probability. Therefore, for stocks, in any given year, the expected return will fall within a range of +/- 20.6 percentage points around the average annual return of 9.6%, or between -11.0% and 30.2%, 67% of the time. For a higher probability outcome of 95%, the range is -31.6% and 50.8% (2 x 20.6 +/- 9.6%).

corporate bonds and over 6.5 times riskier than owning treasury bills in any given year. (Please see the footnote below the chart on this page for a more detailed description of standard deviation).

The table above addresses historical returns and risk, but does it really tell us whether we should own stocks or not? The data does not instill a lot of confidence regarding the likelihood of experiencing positive returns while owning stocks.

However, there are two primary ways to reduce the risk of investing in stocks and improve the

specifically, adding additional asset classes (like bonds) to your portfolio.

As the table on the following page shows, with a one year holding period, there is a 29% chance of losing money – very poor odds. However, by extending the holding period to five years, the risk of losing money is cut in half to 14%, while a 10 year holding period results in only a 4% probability of a negative return. In addition, over a 10 year

time frame, an investor in stocks has outperformed a typical fixed-income investor 80% of the time. A 96% chance of making money and an 80% chance of outperforming the fixed rate alternative are probabilities that are much more acceptable in trying to earn the 9.6% average.

What the statistics in the table do not take into account is the emotional or psychological aspect of investing.

While most investors know that equities have outperformed fixed-income securities over the long



term, not many are prepared to see a 50% drop in the value of their savings, which is what happened

### SUMMARY OF RETURNS FOR DIFFERENT HOLDING PERIODS (1926 – 2008)

Holding Period	Times Equities had Negative Returns		Times Equities Outperformed Fixed-income	
	Number	Percent	Number	Percent
1 Year	24	29%	50	60%
5 Years	11	14%	58	73%
10 Years	3	4%	59	80%
15 Years	0	0%	63	91%
20 Years	0	0%	60	94%

Source: Wachovia Securities, 2009 Newsletter, "Why Invest in Stocks."

from 2000 through 2002 and from 2007 through early 2009. Therefore, for most investors – even those with relatively long investment time horizons – a portion of the portfolio should be invested in fixed-income securities, such as bonds or CDs. While over time, an allocation of fixed-income may reduce returns, it does provide stability so the severe drops in the stock market do not impact the portfolio as much as an account that is comprised of only stocks.

Asset allocation (the mix between stocks and bonds) will have the most impact on the performance of the portfolio, rather than the individual stocks or bonds we buy. Too much exposure in stocks leaves an investor at greater risk of short term losses, while owning too few stocks exposes the investor to loss of purchasing power when their returns do not

keep up with inflation. The right mix is determined by several factors and should be evaluated periodically to ensure changing life circumstances have not dictated a change in portfolio structure. Our job as Investment Advisers is to get to know our clients' investment circumstances well enough to make sure the asset allocation is appropriate before a single security is ever purchased.

In closing, the past 18 months have been very trying times. Most investors are questioning their portfolio structure and whether they want to own stocks at all. All

of us should take a hard look at the factors that influence that decision – specifically time horizon, cash needs, other assets, and general risk tolerance or our emotional ability to withstand sharp short term declines in the value of our portfolios. The bottom line is, a combination of stocks and bonds will typically provide the best balance between stability (which may prevent liquidating stock holdings at the wrong time) and reasonable returns to keep pace with inflation. Hopefully some of the statistics in this newsletter quantify the potential risks and rewards of investing in stocks and help your investment process. ■



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INDEX VALUES AND RETURNS*				
	12/31/08	6/30/09	Price Change	Total Return
S&P 500	903.25	919.32	1.78%	3.16%
Dow Jones Industrial Average	8,776.39	8,447.00	-3.75%	-2.01%
Nasdaq Composite	1,577.03	1,835.04	16.36%	16.98%
Merrill 1-5 Year Bond Index**	106.81	103.05	-3.52%	-0.88%
Consumer Price Index	0.10%	-1.30%***	NA	NA

\*Results according to Bloomberg unless indicated  
\*\*Results according to Merrill Lynch at [mlindex.com](http://mlindex.com)  
\*\*\*As of May 2009