

The Ambachtsheer Letter

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THE 10% EQUITY RETURN ILLUSION: POSSIBLE CONSEQUENCES

“... there is a risk that investors won't boost stocks back to the high levels of the market's headiest days...especially if the market continues to disappoint investors accustomed in the late 1990s to annual stock gains of 20% or more. Most stock analysts today think stocks are more likely to return 10% in the future...”

The Wall Street Journal
December 23, 2001

Consequential Miscalculations

John Maynard Keynes wrote a scathing critique of the terms of the post-World War I Treaty of Versailles (“The Economic Consequences of the Peace”, 1919) because the arithmetic didn't work. The Allies were forcing defeated Germany to pay 24 billion Pounds in war reparations, when by Keynes' calculations, she could at most afford to pay a tenth of that amount without serious risk of financial ruin and political instability. Though he was ignored at the time, subsequent events would prove his analysis was painfully on the mark.

At a very different time, in a very different context, history seems to be in the process of repeating itself. For a number of years now, a small band of financial analysts have been assessing the economic consequences of a stock market for which, from a valuation perspective, the arithmetic stopped working sometime during the 1990s. As was the case with Keynes in 1919, their analyses too continue to be largely ignored.

For proof, we need to look no further than the recent WSJ article quoted above. It seems the market 'pros' today know better than to project the 20% gains of the late 1990s into the future. Apparently, they agree that a 10% return is now a more realistic number. Unfortunately, the arithmetic of the market doesn't work at 10% either. Given the continuing critical importance of prospective long-term stock market returns for all investment fund fiduciaries, we revisit 'the 10% equity return illusion' question in this first *LETTER* of the new year.