

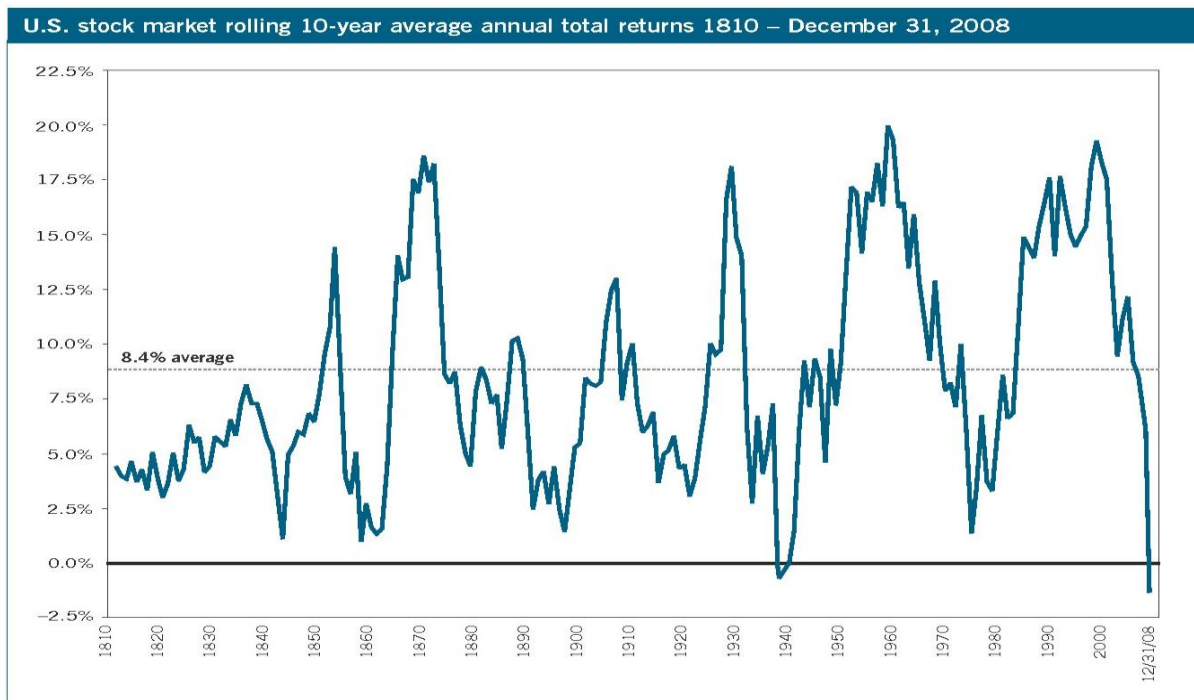


A Lost Decade?

Fair warning: to add to the gloomy economic news, you'll soon be reading about historically negative long term returns for US stocks.

Why? Ten-year returns will now stop counting 1998, which was a big year for stocks, and will start counting 2008, a terrible year for stocks. The 10-year returns will now include two bear markets: the dot-com crash of 2000-2002, and what the managers of Julius Baer Intl Equity have dubbed the "dot-hom" crash of 2008. The 10-year average rate of return is consequently very grim: -1.5% for the Dow Jones Industrial Average. That means that had you invested all your funds in the stock market in one buy 10 years ago, you would have gained nothing; in fact you would have lost 1.5%. This is a new low: the previous worst 10-year return for US stocks was -1.3% in 1938.

The 10-year numbers, of course, are highly dependent on when you start counting. Negative 10-year returns have been very rare. You can see in the chart below, provided by American Funds, that rolling 10-year returns for US stocks have been overwhelmingly positive, with an 8.4% average.



Source: Global Financial Data

The -1.5% trailing return for the past 10 years is bad, but, just like the economy, this is likely to get worse before it gets better. Fran Kinniry, head of Vanguard's investment strategy group, was interviewed on this topic recently by *Financial Advisor Magazine*. Kinniry points out that unless the market returns the same in 2009 as it did in 1999 -- 25% -- the 10-year return will look even worse at the end of this year.

These kinds of trailing returns are going to be disturbing for investors, who Kinniry says are likely to second-guess the concept of "stocks for the long run" unless they understand that a) the numbers are greatly affected by the date one starts counting, and b) rates of return going forward are what matter when making investment decisions, not trailing returns. Vanguard's assumptions on capital market returns, by the way, are: 4.5% on bonds (10 year Treasuries), 9.5% on US stocks, and 2.5% on inflation.

We understand that those of you who have been heavily invested in the stock market for the last decade and have seen nothing for your pains will find the 10-year trailing return numbers concerning, but keep in mind the conclusion that Kinniry drew in a recent Vanguard study:

The last ten years have merely provided the most recent demonstration that, while it's reasonable to expect riskier asset classes will outperform less-risky ones over the longer term, they do not always do so. And this fact is why it is reasonable to expect a risk premium (excess return over risk-free assets) when investing in stocks.

We remain fully confident in the long term risk/reward relationship of asset classes, and continue to recommend adhering to the asset allocation model you've chosen. While difficult to do at market extremes like we are in today, remaining disciplined should serve you well over the long haul.

--Joe Hebert. Posted 02/16/2009.