

February 18, 2009

Report Takes A New Look At Long-Run Stock Investing

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NEW YORK -- Seeing a decade of gains erased in a relatively short period has many investors guessing when the stock market will turn around.

However, hanging on for a rebound may not be the best choice, according to a new study by University of Chicago Booth School of Business professor Lubos Pastor and Wharton School professor Robert F. Stambaugh, titled "Are Stocks Really Less Volatile In The Long Run?"

Their research on stock returns found that equities are actually more volatile over 30-year periods than conventional wisdom teaches, because the principle of uncertainty hasn't been given enough weight by financial advisers.

"If you look backward, [the stock market] does look safer" because there have been rebounds, Pastor said. "But there is so much uncertainty. If you look forward, then this uncertainty flips the result around."

The study, which will be submitted to academic finance journals this week for publication, challenges the popular belief that long-term equity investments are less volatile than short-term investments because the longer time period gives room to recover losses. The report suggests that investors -- especially those expecting to stay in the market for long periods of time -- will want to reconsider the risk in large equity investments.

"Millions of long-run investors bought stocks for their 401K's in part because of that conventional wisdom," Pastor said. "Many of these investors are now questioning their choices...The most recent decade clearly taught us that stocks are not as safe as we thought."

Take a new investor who expects to invest for three decades but loses 40% in the first year. Conventionally, that investor would be told to stay in the market because there is bound to be an upside over the next 29 years. However, Pastor and Stambaugh say that the investor is likely to face more volatility over longer periods than just that single year, meaning more risk awaits.

But while the new study underscores the volatile nature of stocks, the professors say they aren't telling investors to stay away from them and aren't offering alternative investment strategies. Instead, they offer another factor to consider during a time when many Americans with 401K's are looking for the market to turn around. That is especially true for those just starting their 401K contributions, looking for the perfect place to put their money for the next few decades.

In their study, Pastor and Stambaugh incorporated multiple elements into their equations, including uncertainty about future expected returns, uncertainty about current expected returns and estimation risk.

Traditionally, researchers have focused on the concept of mean reversion, or the idea that over time, bear and bull markets cancel each other out and gains are achieved

through economic growth. That conclusion was reached after looking at historical stock returns, as was done famously by Wharton professor Jeremy J. Siegel, who scrutinized stock returns going back to 1802.

While mean reversion is still respected, "it is more than offset by the other components," Pastor said, especially uncertainty. The new study is among the first to compare the effects of mean reversion with uncertainty.

In addition, the trouble with many empirical studies is that they give you a historical account for stock returns but don't provide much for an investor looking forward, Pastor said.

"For example, we may know that stocks have never underperformed bonds over any 30-year period since late 19th century, but there have been very few 30-year periods since then, so there is a lot of uncertainty about historical estimates of 30-year volatility," Pastor said.

A 30-year period is often used in analyses of long-term investment returns.

In a phone interview, Siegel said adding uncertainty will naturally change volatility estimates, but for him it comes down to how one interprets history.

"If you believe that the current economic system is going to hold up and not collapse, which I do, then now seems like a good time to buy more stocks," Siegel said.

At Russell Investments, clients have the risk factor of stocks drilled into them, said Stephen P. Wood, senior portfolio strategist.

"We know that 80% of the time, you will be making investment decisions in an extreme information environment and that's bad," he said, adding, "You need to prepare to take, at minimum, one out of five years at a loss."

Lower long-term volatility also supports the strategy of "life-cycle" funds, which give investors less equity exposure as they approach retirement. Still, steep market downturns haven't forced a change in investment strategy at some life-cycle funds.

Scott Donaldson, senior investment analyst at the Vanguard Group, said they haven't made significant changes to the portfolio of the Vanguard Target Retirement 2025 Fund. Still, stocks are certainly going to be more risky, "even for that younger investor with more flexibility," he said.

Life-cycle funds have been growing in popularity as the set-it-and-forget-it option for long-term investing. Donaldson said participation in similar funds at Vanguard has gone from \$3 billion to around \$200 billion over the past decade.

But it remains to be seen how the current market volatility will be factored into the investment philosophy of funds like these, which allocate greater funds into equities for younger investors.

In the end, things are very much like Danish physicist Niels Bohr said: "Prediction is very difficult, especially about the future."

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