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Rethinking Stocks for the Long Haul

Investors raised on the wisdom of the DIY boom years may be taking on more risk than they know with their retirement nest egg

By Chris Farrell

It's one of the most powerful ideas in modern personal finance: Over time, stocks become safe investments.

Sure, stocks are extremely volatile or highly risky for anyone investing with a time frame of five years or less. Yet scholarly and Wall Street quant research, much of it dating to the early 1990s, showed that once the investment time horizon is extended to 15 years or more, the risk of owning equities dramatically shrinks while the financial rewards remain large. Equity investors have earned a remarkably consistent 7 percent real return (about 10 percent after adding back inflation). The risks of owning stocks for the buy-and-hold investor over 10, 15, 30 years and more, is less than socking money into bonds and bills over comparable time periods.

Little wonder the stock market became the favored solution to almost every long-term money problem in recent decades. Saving for your toddler's college tuition? Load up on stocks when she's young. Investing in your 401(k) plan? Stocks are the place to be. And forget the old shibboleths about entering retirement with a portfolio made up of conservative fixed-income securities. No, financially savvy retirees kept a healthy portion in of their portfolios in equities. After all, men retiring around age 60 could expect to live another 20 years, on average. For women, it was almost another 24 years. The elderly equity investor could expect to live long enough to offset the risk.

Of course, the notion that equities are a safe asset took a big hit during the financial crisis of 2008. Nevertheless, the bullish approach toward equities remains remarkably durable, especially with the market up 90 percent since reaching its low on Mar. 9, 2010. Perhaps most telling, the long-term positive view of equities is deeply embedded in the construction of target-date or life-cycle funds. These funds are marketed to participants as a relatively conservative choice, yet they are built around the idea that equity risks are smoothed over time.

AN OPPOSING VIEW

Yet the combination of recent experience and a substantial body of finance research makes a convincing case that there's no safety in owning stocks for 10, 15, 20, 30 years—quite the opposite. Far too many investors may be taking on more risk than they know with their retirement nest egg in target-date funds or comparable portfolios put together by a DIY generation of savers. The risk in stocks is that they may stay down for a long time, wiping out a generation of savers who could be long dead before the market starts climbing again.

Take those target-date funds. They are increasingly popular as a core offering in many defined-contribution pension plans, accounting for almost two-thirds of the $319 billion in fund assets (as of November 2010). These funds are designed to load up on riskier stocks when a worker is young and shift money into more conservative investments as retirement looms. Yet these funds continue to hold a considerable amount of equity past the retirement date, on the theory that retirees will need the boost from equity returns throughout retirement.

For example, the average target-date fund with a retirement target of 2010 had half its portfolio in equities going into 2008. Fund values subsequently fell 23 percent, on average, during the bear market. In response, a number of the funds cut back on their equity exposure the following year. Still, equity allocations currently range between 65 percent and 26 percent for the 2010 funds, according to Morningstar, an independent advisory firm. The 2020 target-date funds have, on average, 68 percent of the portfolio in equities. Any fund with a 2045 date or later has at least 85 percent of assets in stocks.

IS THE FUTURE LIKE THE PAST?

The record of the past 10 years makes you wonder if that's a great idea. After all, the benchmark Standard & Poor's 500 market index sported an annual average loss of 0.95 percent a year from Dec. 31, 1999, through Dec. 31, 2009, compared with a 6.3 percent average yearly gain in the Barclays Capital Aggregate taxable bond index. Stocks even lost the performance sweepstakes to U.S. Treasury bonds over the preceding 15, 20, and 25 years.

What's more, scholars have taken another look at stock market data and concluded that perhaps recent experience isn't an anomaly, but the norm. Consider the following:

— Uncertainty compounds over time. A striking contribution to the stocks-are-riskier-than-thought school is the recent study, "Are Stocks Really Less Volatile in the Long Run," by Lubos Pastor, an economist at the University of Chicago Booth School of Business, and Robert F. Stambaugh, an economist at the Wharton School at the University of Pennsylvania. Like their scholarly peers who are more positive on equities, these two believe bull markets and bear markets largely cancel each other out. In other words, stocks are "mean reverting" over the long haul. It helps explain why U.S. stock returns have been so consistent over time, about 7 percent after inflation since the early 1800s. Nevertheless, that information is historic. Investors looking ahead over the next several decades don't know what will be the average rate of return. The statistical technique they used to measure that uncertainty suggests that the volatility of stock market returns at 25 years is 1.3 times the volatility of a one-year horizon (and nearly 1.8 times for 50 years).

Or in layman's terms: Put yourself in the shoes of an intrepid investor in 1900. Both the U.S. and Argentine equity markets looked extremely attractive. Yet the buy-and-hold investor would have pocketed a small fortune in U.S. equities and would have been essentially wiped out in Argentina over the course of the century. "We don't know what the equity premium will be over the next 30 years," says Pastor. "And that uncertainty compounds with time."

— Stock market busts are common, and if you retire at the "wrong" time, the downturn could be financially devastating. Take these calculations from Paul Kaplan, vice-president for quantitative research at Morningstar: From 1870 through June 2009, $1 invested in a real U.S. stock market index was worth $5,179 (in 1869 dollars). That's a compound annual real total return of around 6.4 percent. Yet along the way the market went through 17 peak-to-trough declines of more than 20 percent. Two of the three biggest declines occurred in the past decade.

History's message is that investors need to assign a much higher probability to the risk of an equity bust around the time they might retire. After all, the stock market has declined 20 percent or more every decade or so, on average. "You can wake up in the morning with half your wealth gone," says Kaplan. "The time horizon reassurance disappears."

— If stock market risk fell the longer the investment was held, the cost of owning options to protect the portfolio from a "shortfall loss" should also decline. (A shortfall loss is a loss relative to what an investor could have earned by putting money into a safe asset over the same time period, such as U.S. Treasuries.)

In an elegant exercise in 1995, Professor Zvi Bodie of Boston University tapped into the insights of option-pricing theory to challenge the notion that stocks became less risky for the buy-and-hold investor. Yet the cost of insuring a portfolio with options goes up, not down, with time. For instance, he estimated at the time that a one-year shortfall "put" option would cost 7.98 percent of the portfolio, and at 30 years the cost of the shortfall insurance jumped to 41.63 percent. (At 200 years the comparable number was 84.27 percent.)

Of course, all this isn't a brief against stocks. It's just an argument to take the risks inherent in owning stocks seriously. Target-date funds aren't a conservative option for retirement savings. They're a big bet on a flawed idea.

"I am less invested in stocks than before," Pastor says. "I am pretty young, in my late 30s, and I'm a tenured university professor, but I have a greater appreciation of the risk in stock investing going forward." That's good advice for all savers.

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