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Future Stock Market Returns-- Investors Need to Readjust Expectations

How much should one count on double-digit returns from the stock market to feather one's retirement nest egg? Research on future earnings shows that it might be necessary for all of us to adjust our expectations downward and settle for a decent, but lower return, over the next 5-10 years.

As recently as 6 months ago, investors polled by the Opinion Research Corp. expected to achieve long-term stock market returns of 13.5%. Now more recent surveys show they expect only 9.5% annually. So what is realistic to expect, since I'm sure all of you want to live comfortably in your retirement, send your kids through college or buy that vacation house?

Since 1926, the stock market average return has been 10.7%, even counting the last two lousy years. Roger Ibbotson, a Yale professor and investment research guru, forecasted in 1999 that long-term gains would average a nice 11%. Quoted recently in the New York Times, Ibbotson has now redone his research and come up with a revised forecast of 9.37% annually over the next 10 to 25 years. That may not sound like a big drop from 11%, but if you were saving \$25,000 per year over the next 25 years, the decrease in expected returns would result in savings of \$2.2 million, compared to almost \$2.9 million, a drop of 21.8%. That could conceivably make the difference in whether you can retire on time and with the same standard of living.

Eugene Fama, a professor at the University of Chicago, is more pessimistic than Ibbotson; he feels

stocks will return no more than 7.5% a year, and perhaps considerably less. Such a drop in the savings scenario above would result in a nest egg of \$1.7 million, a drop of 41.4% from \$2.9 million. Definitely a possible retirement buster.

What does this mean for your future plans? Well, bonds and cash are still expected to give investors the same 5% to 6% they have in the past, with much less volatility than stocks. So the first advice is to make sure your portfolio is not too aggressive for you: investors sometimes think that the only way to get ahead is to have their portfolio filled with "hot"

"Future stock market average returns are forecasted to be 9% annually over the next 10 to 25 years, down by 2 percentage points from the 11% forecast in 1999. "

stocks and no bonds or cash. Just the opposite could be true - - just look at what has happened over the last two years, with some undiversified investors losing half or more of the value in their portfolio. It will take them possibly years to recover from the results of the 2000-2002 volatility.

Lower returns may also mean that you may have to consider saving more and spending less. That may not sound like profound advice, but consider this: since the early '90s, the savings rate in the U.S. has dropped alarmingly from 8.7% to the current 1.6%. So people are obviously hoping that stock market returns alone will get them to their goals, when in fact they may just need a healthy dose of old fashioned savings to make up for tepid stock market returns.

Can You Trust Wall Street's Stock Recommendations?

Even though Wall Street has paid big penalties via the findings of Eliot Spitzer, New York State's Attorney General, it is still more interested in coddling its investment banking clients than in performing impartial, fundamental research on stocks. As a result, the big brokerage firms continue to do a disservice to small investors who trust them, by hardly ever recommending that a stock should be sold.

The Wall Street Journal recently had a fascinating piece entitled "Should You Trust Wall Street's New Ratings?" In essence, the article said that brokerage firm stock analysts are still reluctant to say "sell" to investors. It turns out that, under pressure, Merrill Lynch, Morgan Stanley and other Wall Street firms have simplified their stock rating systems to essentially a) Buy, b) Hold and c) Sell. So far so good, but

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the article went on to say that, with the exception of Morgan Stanley, only a tiny fraction of stocks they cover fall under the "sell" rating. For Merrill Lynch, it is 5.8%, Goldman Sachs 1.5% and CS First Boston an incredibly low 0.4%.

"Not much has really changed," says Chuck Hill of research firm First Call. The anti-sell bias is very entrenched. Brokerage firms who are beholdened to investment banking clients don't like to issue a lower rating on stocks, since such a change often causes the price of the stock to decline. So there's still a code investors need to attempt to break - - often "hold" really means sell, for instance. It's deceptive, but at least the broker never has to utter the word "sell."

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So how does the small investor know when to hold them and when to fold them and not depend on their broker's often less than objective recommendation? The answer is to do a little homework on your own and use truly unbiased research sources for your stock ratings. And I don't mean Sanford Bernstein or Prudential, since even those seemingly independent firms rate as "sell" only 2.0% to 3.5% of the stocks they cover. Rather, I'm referring to publications like ValueLine which rates a reasonable 23.5% of the 1700 stocks it covers as "sell," or Morningstar, which analyzes about 471 stocks, 22.5% of which are rated as a "sell" (I use both sources, by the way, to analyze my clients' stock holdings).

There is the possibility that stricter regulations will be implemented to require brokerage firms to be more objective in their research reports. The hope is that when they are required to publish their distribution of ratings (how many stocks they recommend holding versus selling), the number of sell ratings will increase dramatically. In the meantime, however, the old adage "let the buyer beware" could be modified to "let the investor beware." Ask whoever is your financial advisor—whether it's a broker or financial planner—how they determine what to buy, hold or sell.

A Parting Thought...

"The instant dissemination of information today carries a substantial cost: the tendency among investors to act first and think second."

About the Advisor...

Christopher Kuehne is an independent, fee-only, Certified Financial Planner (CFP), Registered Investment Advisor and NAPFA-Registered Financial Advisor. He has worked in the financial services industry for 19 years in various capacities, including 12 years on Wall Street as a Vice President at Merrill Lynch and Bankers Trust Company. Mr. Kuehne has an M.S. in Economics from Carnegie-Mellon University, is a member of the Financial Planning Association (FPA) and the National Association of Personal Financial Advisors (NAPFA).