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Vanguard’s Forecast of Future Returns

By Editor Test *Wed, Mar 3, 2010*

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Recent research from The Vanguard Group suggests that over the next ten years the annualized real returns will most likely be 6% for stocks and zero to 2% for bonds.

Those estimates are based on the historical relationships between on earnings-to-price ratios (6.75 for stocks in December 2009) and the 10-year Treasury bond yield (3.6% on December 31, 2009).

But the range of possible returns is much wider. In the past, similar E/P ratios and bond yields have led to annualized 10-year stock returns of between zero and 15% and bond returns of between minus-3% and 8%.

These projections are included in a February 2010 paper from Vanguard called, “2009: A Return to Risk-Taking,” by Christopher A. Philips, CFA.

Philips makes the case that, contrary to conventional wisdom, diversification didn’t fail during the financial crisis of 2008. His data shows that even though investors who held bonds weren’t entirely protected during the crash, they suffered less than those who didn’t.

For example, somebody with an all S&P 500 Index portfolio on October 9, 2007 would still have been down about 25% on December 31, 2009. But a person with half their money in a bond fund matching the performance of the U.S. Aggregate Bond Index would have been down only about 10% at the end of 2009.

Why the stock market rebounded

Market analysts rarely suggest that the Federal Reserve ever uses monetary policy to lift the stock market, but Philips’ paper comes close. “It can be argued,” he wrote, “in fact, that the actions of both the Fed and the U.S. Treasury were largely geared toward reviving investment in riskier assets.”

“With yields of Treasury bills hovering below 0.25% for the entire year,” Philips continued, “many investors needed little incentive to abandon the flight to quality that characterized the market crash and financial crisis of 2008 and to gravitate, instead, toward riskier assets in search of higher yields and greater potential returns. This new focus on riskier assets helped drive prices up across the board.”

The Vanguard paper also shows that U.S. investors have been more cautious in the aftermath of the 2008 equity crash than they were during the recovery from the dot-com bust earlier in the decade.

During the dot-com bust, money surged from stocks to money market funds, but then flowed back to stocks as the market rebounded in 2003. During the 2008 crash, money at first fled to cash and Treasury bonds, and then flowed more to longer-term bonds than to stocks.

Philips thinks that the dip to zero interest rates in 2009 (compared to 1% in 2003) may explain that difference. In 2009, the spread between Treasury bills and the broad stock market was 4.3% at the market bottom. In 2003, the spread was only 2.7%—giving investors little reason to be satisfied with bonds.

But by loading up on longer-term bonds, he said, investors are increasing their vulnerability to tightening by the Fed, because rising interest rates would depress the market price of existing bonds and hurt total returns.