Equity Premium and Expected Returns
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You may have heard on the news or read in a financial publication some reference to the "equity risk premium" and its implication for future returns for the stock market. These discussions have been motivated by the extraordinary performance of stocks (as defined by the S&P 500 index) for the five years ended in 1999; the publication of books like "Dow 36,000: The New Strategy for Profiting From the Coming Rise in the Stock Market", which, not coincidentally, was published in 1999; and the subsequent sell-off in growth stocks last year. I suspect that more often than not these discussions create anxiety for investors who own stocks in their personal or retirement accounts since the conclusion is almost always that investors should expect much lower returns on stocks in the future—usually stated as five years or more.

In general, I can't argue with much of what's written and talked about in this regard. In fact, one of my most important sources of financial research, Eugene Fama, Sr. at the University of Chicago, has written a paper on the subject and concludes that the expected return for stocks using accepted valuation models is much lower than returns of the recent past and lower than the average investor's expectation.

The purpose of this article is to remind TAM investors that they are not average investors and because of their commitment to a diversified portfolio that includes more value stocks and small company stocks than "the market", their view of expected returns should be very different from the average investor.

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The Past
As the first chart on the next page shows, the 1995-1999 period for large U.S. growth stocks, as measured by the S&P 500 index, was very unusual and the index outperformed other asset classes by a wide margin. After just over 13 months that margin has narrowed considerably. Over the long-term, large and small value stocks and small stocks in general have done better. This last relationship is what drove our asset allocation decisions in the first place and guides us now. To keep the comparison consistent, I used annual returns...
throughout, but keep in mind that the 5.6% annual difference for Small Value since 1964 translates into a huge difference in total return—your dollar would have grown over five times as large.

Today

Returns we receive on stocks in the future depend on the prices we pay today. If we pay high prices relative to a company’s earnings, for example, that means we have high confidence in that company’s ability to continue to grow earnings at the same or better pace in the future. Another way to say this is that we perceive less risk in the company’s earnings potential. On the other hand, companies that sell at low prices relative to earnings reflect a lack of investor confidence—they perceive greater risk in the earnings potential of these companies. Unless you believe in “a free lunch”, the lower perception of risk of the higher priced stocks (usually “blue-chip”, brand rich, established companies) should result in lower returns to investors over time.

This is not always the case, of course, as evidenced by the 1995-1999 period. Companies that almost everyone would consider less risky have produced the highest returns. This is the nature of risk—there is no sure thing, especially over the short-term. But as the chart above shows, over time the lower risk/lower return principle has applied. You can also find individual companies that seem to sell perpetually at a high P/Es and continue to move higher in price. Until last year Microsoft was one of these. But predicting these companies in advance is impossible. There is no reason to believe these stocks can’t “regress to the mean” as competition in their industry changes. This may very well be happening with Microsoft as we speak. More and more computing power is moving from the desktop to the Internet and will almost certainly have an affect on a company that derives over 70% of its revenues from a desktop operating system and applications.

The stock market is really just a big voting machine with a lot of dimpled ballots (confused investors). And the flow of information is so efficient that at any given time we can gauge the optimism or pessimism of investors by looking at average prices vs. average earnings per share. This doesn’t mean we can profitably trade on these observations. It simply means that we can observe investor attitudes and risk perception by looking at current prices. And as I said at the start, current prices determine future returns. The chart below shows the change in investor confidence and perceived risk over the past six years by showing the changes in price/earnings ratios. It’s not hard to conclude that investors have felt pretty good about large growth stocks, while their perception of small and value stocks have remained about the same or declined. (It should be noted that P/E ratios could change as a result of the denominator, earnings, changing as well. For example, if earnings fall and prices remain unchanged, the P/E will expand. This has not been the case with large growth stocks recently. Earnings have risen and prices have risen much higher.)

The Future

Unfortunately, I cannot tell you with certainty that value and small company stocks will outperform growth stocks over the next five or ten years. In fact, if the economy goes into recession, a case can be made that value and small company stocks could do worse (that is essentially the source of the risk premium for these stocks). But current levels of price to earnings, book value, and dividends suggest that there is still a distinct difference in investor expectations for growth and value and large and small company stocks. The asset class returns last year and so far this year may be indicating that investor perception of risk and/or expected returns is changing. If they see less certainty in the earnings potential for large growth stocks, prices will adjust downward. Value and small—the forgotten asset classes—could continue to be the beneficiaries of this attitude change.