# Alley Company Commentary
## Investing for the Long Term

*"It's not easy to think long term when the news is bad and bombs are going off around you."* Today's investor

As a result of the brutal bear market in stocks, long term investment thinking has gone askew. Investment decisions are made in large part by combining the analysis of historical returns with the outlook for future returns. While the outlook for future returns requires vision, a significant part of the forecast is based upon the analysis of historical data. Since history tends to repeat itself, studying past long term trends for asset class returns can provide excellent insight as to what we might expect to see on average in the future. *Investors must have some sense of long-term perspective in order to maximize the effects of compounding*.

Complicating the long-term nature of making investment decisions, is near term performance. Strong near term performance tends to cause investors to want more of an asset class, while weak near term performance causes investors to want less. *This phenomenon causes asset allocation percentages to get out of sync with the long term objective*.

The long term targeted asset allocation decision is one that is usually good for a *long time*, and requires only minor changes through time, if a true long-term perspective is operative. Allocations certainly should be tweaked as the future fundamental outlook changes relative to what the historical return analysis might suggest. And, when near term performance, either positive or negative, skews the desired asset allocation weightings away from the long-term desired levels, steps should be taken to realign them. *Sectors that have generated outsized positive returns within an asset allocation mix eventually revert to the mean, that is underperform and return to their traditional level. The obverse is true after having generated outsized negative returns.*

The outlook for U.S. stocks is currently intriguing given the negative returns investors have recently experienced in the bear market. It is well documented in the table below that large cap U.S. stocks have generated the most attractive risk adjusted returns through time.

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

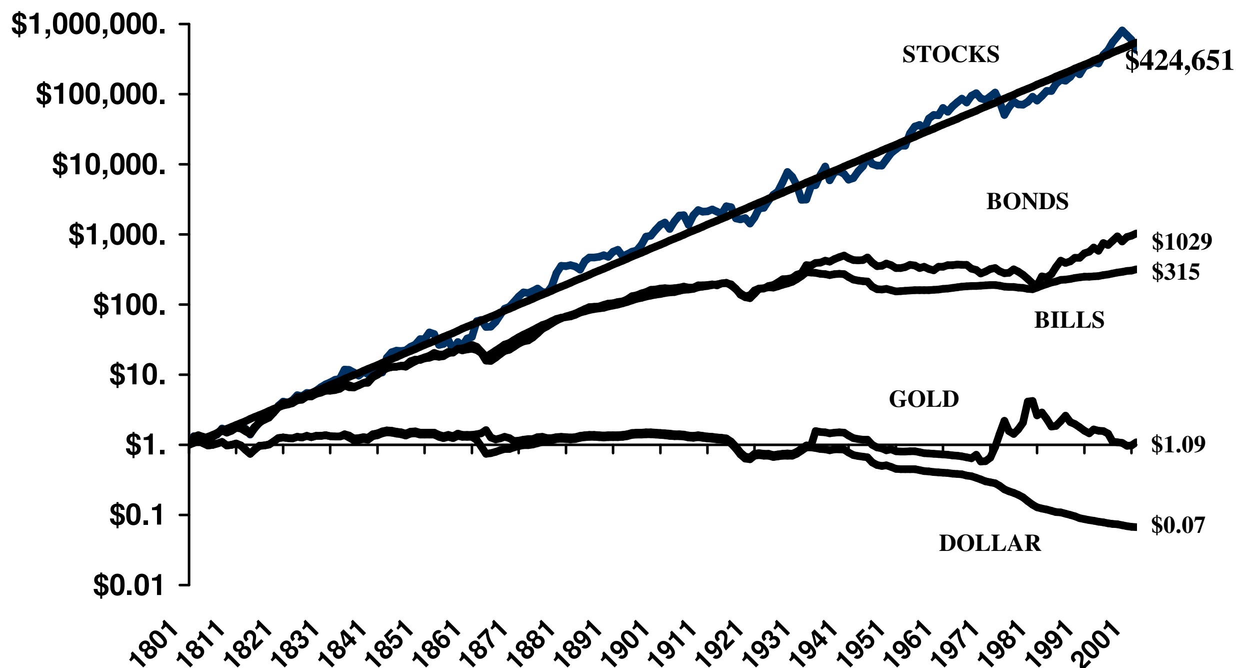
## Return vs. Risk

| Asset Class | Index/Source | 1945-2000<br>Annualized Return | <br>Standard Deviation |
|---|---|---|---|
| U.S. Large Capitalization Equities | S&P Composite Index Total Return | 12.9% | 16.7% |
| U.S. Small Capitalization Equities | Dimensional Fund Advisor Small Company Fund | 14.4 | 25.6 |
| EAFE Equities | MSCI Europe, Australasia, and Far East (EAFE) Index | 12.4 | 25.7 |
| Emerging Markets Equities | International Finance Corporation Composite Index | 12.4 | 31.9 |
| U.S. Long Treasury Bonds | Ibbotson Associates Long-Term Government Bond Index | 5.6 | 10.6 |

Source: Morgan Stanley

The table illustrates that S&P 500–like stocks, or core equity as we call them, have generated competitive returns vs. the other equity asset classes shown with 50% to 100% less risk (standard deviation of returns). Versus bonds, large cap stocks have provided more than double the return with about 50% more risk. Yet in the aftermath of the 2000-2002 bear market, investors have begun to question the long term viability of investing in common stocks.

A study by Jeremy Siegel, a professor of finance at the University of Pennsylvania's Wharton School, concludes that over the past 200 years, U.S. stocks have returned +6.7% per year after adjusting for inflation. The chart below shows the *real* return history of one dollar invested 200 years ago for stocks, bonds, T-bills, gold, and the U.S. dollar.




Source*: **Stocks for the Long Run*** by Jeremy J. Siegel

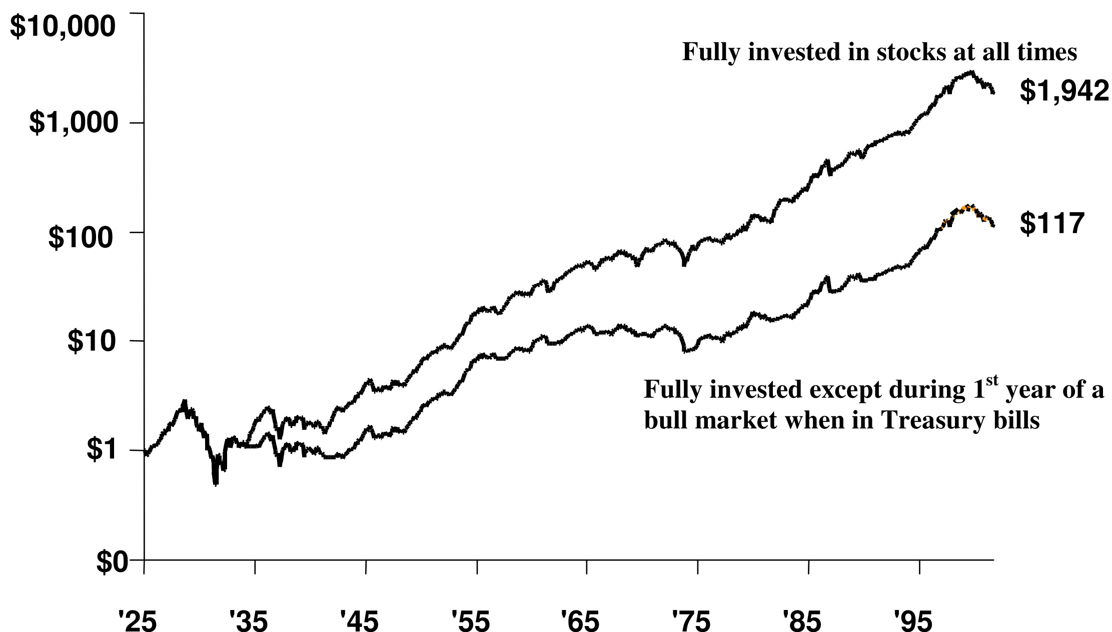
The U.S. has been through a depression, recessions, world wars, among other things, and stocks have still significantly prevailed over all other asset classes after adjusting for inflation.

The bear market of 2000-2002 is one of the most vicious on record with the NASDAQ declining 75% from the peak and the S&P declining nearly 50%. Siegel's study goes on to show that anytime the stock market declines more than 40%, the subsequent 5 year *real* returns averaged +8.6% per year and were never negative. The 1973-74 post-bear market 5 year *real* returns were +6.5% per year, as a specific point of reference.

Taking it one step further, Morgan Stanley and Ibbotson Associates studied the past 75 years and determined that *if investors missed the first year of every bull market, stock market returns were dramatically reduced*. One dollar invested in stocks in 1926 became $1,942 in 2002 if it stayed invested throughout the period, while the same dollar became only $117 if it missed the first year of every bull market. This suggests that the first year of bull markets have been the most powerful, probably because the pendulum at the end of each bear market swung too far in the negative direction.

**Missing the First Year**

**Total Returns January 1926 to August 2002**




Source: Ibbotson Associates, Morgan Stanley Investment Management

These studies show that if the U.S. economy remains sound, and recovers like it usually does, stocks are likely to do well in the aftermath of the 2000-2002 bear market. Even though the financial markets are cyclical and are driven by fear and greed, America is the greatest wealth-creating machine in history, and is likely to get back on track again.

*Asset "allocation drift" has likely taken place, where stocks are now at a lower percentage of the mix as a result of stocks doing poorly while bonds and real estate have done well*. As stated earlier, asset class returns tend to revert to their mean potential. In the current environment, stocks have likely experienced much of their reversion to the mean, as they are currently trading at 1997 levels, while bonds and real estate are at their respective high water marks. If we allow the virtues of true long term investing in our asset allocation decisions to hold, then now is the time to stay committed to stocks, if not raise the allocation to reflect the desired long term objective.

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