

The stock market: Taking your money to Vegas?

By Dan Richards

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It's at times when we're at extremes of sentiment - both on the upside and the downside - that smart people sometimes say foolish things.

Take the recent claims by Wall Street experts that U.S. housing prices could never go down and a leading Bay Street economist's prediction of \$200 (U.S.) oil in the near term.

On the same note, a recent article on online investing quoted Meir Statman, a finance prof at Santa Clara University in California: "Even if the odds are that markets will go up rather than down, you venture into markets with no more money than you can afford to lose. "

What are we to make of this? That the world's smartest and most disciplined investors - Warren Buffett, the Yale and Harvard endowments, the Ontario Teachers' Pension Plan - are putting money into the stock market with a realistic possibility that they might lose it all? That

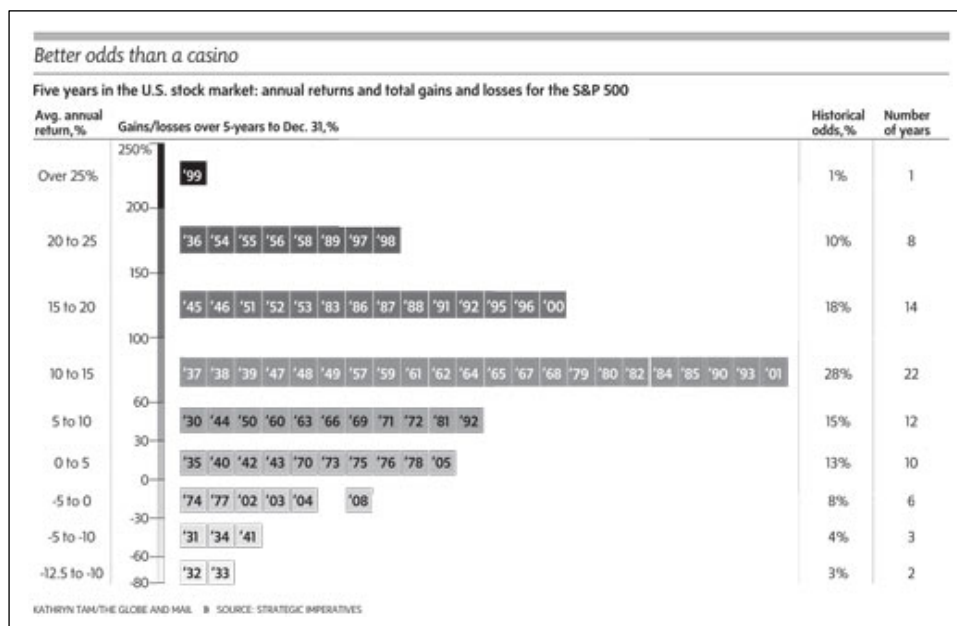


investing is akin to a casino and buying stocks equivalent to going to Vegas?

The best proxy for the experience of investing in a broadly diversified stock portfolio is the Standard and Poor's 500, reflecting the 500 largest U.S. stocks. If we go back to 1925 (as far back as we have good data), what's been the experience for people who invested for five years and held on, reinvesting dividends along the way

Since 1925, we have seen 77 five-year periods, from 1925 to 1929, 1926 to 1939 and so on, right up to 2003 to 2007. During this time, the average return on the S&P 500 was 10 per cent, yielding typical cumulative gains over a five-year period of 60 per cent.

Of course, the average experience masked big variations along the way. The accompanying chart shows what the investment experience over those five-year periods looked like.



over 20 per cent. Investors who participated in those previous years still ended up with an average return of between 9 per cent and 13 per cent in the 10 years to 2001, 2002 and 2003, even after three money-losing years where overall markets were down 40 per cent.

Here are four observations on returns over five-year periods.

1. Investors lost money in 10 five-year periods, or 13 per cent of the time. Contrast the 13-per-cent odds of a loss with the 87-per-cent chance of a gain - not a guarantee but far better than you'll find in any casino.
2. In five of those 10 money-losing periods, your total losses were difficult but manageable - under 4 per cent in the periods ending 1977, 2002 and 2003; 11 per cent and 13 per cent in the periods ending 1974 and 2004. These declines took place in the oil-shock induced bear market of the early 1970s and the tech crash from 2000 to 2002.

Note that the 2000 - 2002 crash was preceded by the best periods for investors, in which average returns in the late 1990s were well

3. The three periods in which investors lost between 30 per cent and 60 per cent of their capital, averaging losses of 5 per cent to 10 per cent annually, were the periods ending in 1931, 1934 and 1941. These were indeed painful periods, reflecting the Great Depression and the uncertainty of the early years of the Second World War.
4. Finally, you have the disastrous five-year periods ending in 1932 and 1933, during the worst years of the Great Crash, in which investors lost 10 per cent a year and saw over 60 per cent of their capital eroded.

And how about the five-year period ending in 2008? If the S&P 500 ends the year at the same level it was on Friday Dec. 5, investors will see a five-year loss from the beginning of 2004 to the end of 2008 of about 12 per cent- painful but

not close to the damage done to markets in the 1930s.

The bottom line is quite clear. There have been periods in the past where investors got very badly beaten up (although perhaps not quite as badly as those who equate investing with going to Vegas would suggest) - but these periods took place in the 1930s, in a very different environment than the one in which we operate today and at a time when governments around the world made tragic errors in fiscal, monetary and trade policy.

By contrast, in the 63 years since the end of the Second World War, the worst five-year loss suffered by investors has been 15 per cent. If we want to be extreme, we could double that and perhaps say that investors should be prepared for a five-year loss of as much as 30 per cent - still a very different story from the dramatic losses in the 1930s.

In the end, perhaps Meir Statman does have one valid point - if investors have a short time horizon, want to take concentrated flyers in individual stocks or industry sectors and then amplify their risk level by leveraging up their investment with borrowed dollars, they should only invest as much as they're prepared to lose and consider Vegas as an alternative destination for their dollars.

On the other hand, based on all the evidence at hand, it's quite clear that investors with the commitment to hang in for at least five and

preferably 10 years and with the discipline to maintain a broadly diversified portfolio should have little to fear from trusting at least some of their financial future to the stock market.

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