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Stocks or Bonds? The Pros Say...

For long-term investors, equities may look scarier, but they seem to be poised for stronger returns over time

By Jonathan Burton
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With so much volatility in stocks, many investors have increasingly favored the relative security of bonds and bond mutual funds.

That may be a mistake.

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Jonathan Burton discusses the long-term outlook for stocks and bonds.

Using history as their guide, and weighing current stock valuations and interest rates, various investment pros believe stocks have a much better chance than bonds to beat inflation in the long run.

That isn't to say they are particularly bullish on stocks. It's just that they are profoundly pessimistic when it comes to bonds. As a result, the consensus among the investment experts interviewed for this article is that U.S. stocks will outperform long-term U.S. government and corporate bonds over the next 20 to 30 years and resume their traditional role as the safer hedge against inflation.

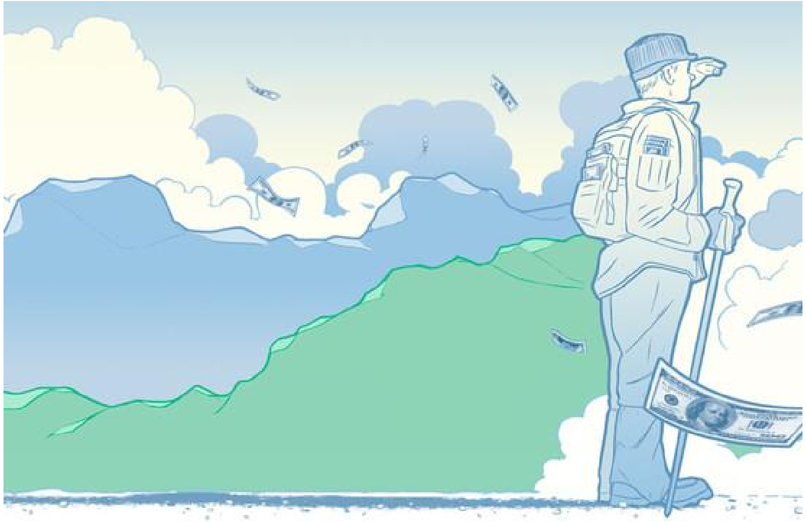
"I certainly wouldn't get out of the stock market," says Jack Bogle, founder of Vanguard Group, which offers funds of many types of investments, including stocks and bonds. "The risks we face today are deeply serious," he adds, "but the odds are that stocks will do better" than bonds.

It wouldn't take much for equities as a class to post better returns than they have in recent years. In the so-called lost decade from 2000 through 2009, the return on the Standard & Poor's 500-stock index, including dividends, averaged a negative 0.9% per year, according to investment researcher Morningstar Inc. But even at current prices, such large-cap stocks probably won't deliver the spectacular 18% annualized average gains that a generation of buyers enjoyed from 1980 to 1999. Still, right now stocks, particularly dividend payers, look more attractive than bonds—especially if down the road there's resurgent inflation, which whittles away fixed-income returns.

"The bond outlook is extraordinarily bad," says Jeremy Siegel, a Wharton School finance professor and author of the best-selling "Stocks for the Long Run." Bonds are in vogue and overvalued, much as stocks were at the end of the 1990s, he says. After 30 favorable years of declining yields and rising prices, the best case for bonds over the next couple of decades is a return of "zero" after inflation—and more likely a negative outcome, Mr. Siegel predicts.

Bond-Fund Investors, Beware

If interest rates climb in future years, as is likely from today's very low levels, the prices of existing bonds with lower rates will fall. The impact may be felt more keenly by holders of bond mutual funds and exchange-traded funds than by investors who have bought individual bonds. The latter have the option to collect their bonds' full face value at maturity, while bond funds don't mature.



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"We're in the very mature stages of the secular bull market in bonds," says David Rosenberg, chief economist and strategist at Toronto-based investment firm Gluskin Sheff + Associates Inc. "I'm not bearish on fixed income, but when the five-year [Treasury] note is below 1% you know the game is not over, but it's close to being over."

Stock prices, in contrast, don't appear inflated. At the end of 2011, the Standard & Poor's 500-stock index traded at just under 13 times estimated 2012 earnings—cheaper than its 17.5 average price/earnings ratio since the end of World War II, according to S&P Capital IQ. Compare that with March 1999, when the S&P 500 traded at 33.5 times earnings.

A Lower Bar

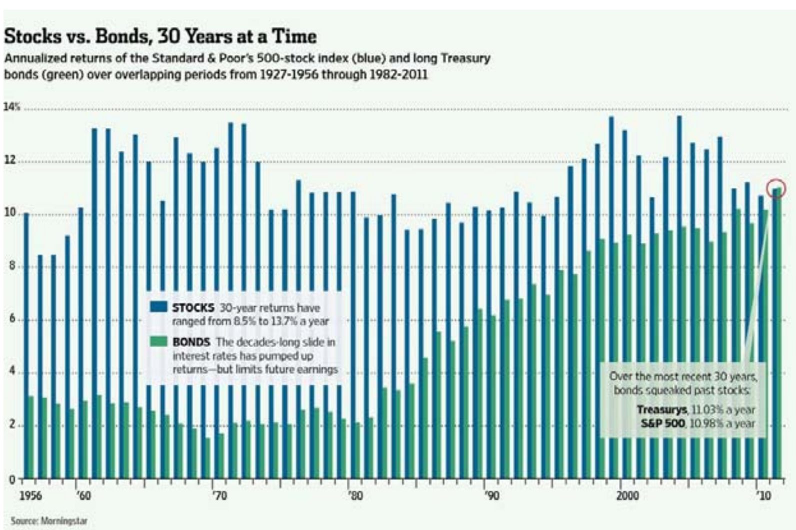
It's those kinds of valuation comparisons that lead experts to see room for stocks to move higher—if only by a little, at first. But the goal for most investors currently seems to be staying ahead of inflation, not hitting home runs. And for many experts, stocks still fit that bill better than bonds.

"The equity market doesn't have to do too well to beat the bond market," says Roger Ibbotson, a Yale University finance professor and founder of investment-data pioneer Ibbotson Associates, a unit of Morningstar.

Indeed, coming years may begin to see a more normalized investment picture, in which U.S. stock buyers are rewarded for taking risk and equities outperform bonds. Typically the 10-year Treasury is the starting point to measure this "equity risk premium," which for more than eight decades has given stock investors around four percentage points of return over the prevailing Treasury yield.

Reading Treasurys

Nowadays, the 10-year Treasury yielding 2% suggests below-average U.S. stock returns of 6% annualized over that time frame, including dividends and before taking inflation into account; a 50-50 mix of stocks and bonds would post a nominal return of 4% before inflation, and, assuming 2% inflation, a 2% return after inflation.



"People might want to not put as much in the stock market [as they did in the past], but the fact that people are unwilling to take that risk now might mean that risk premiums are higher than they've been historically," Mr. Ibbotson says. "Long term, it's a fine time to buy stocks."

Long-range forecasts for stock returns vary among experts. Wharton's Mr. Siegel is one of the most optimistic. "When you buy stocks at less than the average valuation, which is 15 [times earnings] over the last 50 years, returns have been even better than the long-run average, which is 6% to 7% after inflation," he says. "From these levels you could expect 8% to 9% average real returns from stocks."

Meanwhile, Messrs. Bogle and Ibbotson and Ted Aronson, a founder of investment adviser Aronson Johnson Ortiz, expect 7% from U.S. stocks before inflation over the next few decades.

Others foresee even more modest gains from stocks, but returns that still outpace both bonds and inflation. Rob Arnott, chairman of asset manager Research Affiliates LLC and author of seminal studies on investment risk and return, says an annualized average return of 5% is likely for the next 10 years.

Adjust Expectations

Each of these scenarios pales against the 9.8% annualized total return for the S&P 500 since 1926, the 5.7% yearly return over that time from long-term U.S. government bonds, and the 8.2% yearly gain from a portfolio of 60% stocks, 20% bonds and 20% cash.

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And therein lies an important message for investors: Stocks may be a long way from generating bullishness, the experts say, but they still offer probably the best chance to increase one's nest egg and stay ahead of inflation.

"The No. 1 thing people must do is bring down their return expectations," Mr. Arnott says. "If you're expecting 8%, you're going to behave differently than if you're expecting 4%; you're going to spend more freely and set your plans to retire earlier. At 4%, you're going to be saving more aggressively and planning to work longer."

Mr. Arnott doesn't believe that stocks are inherently better than other investments. Indeed, he believes too much attention was paid to equities in the past. People need to look at the "whole spectrum of investments available to them," he says, not just stocks and bonds.

In addition to mainstream equities and fixed income, he says, investors need a "third pillar" for their portfolio: assets that offset inflation. Chiefly, commodities and the stocks and bonds of commodity-producing countries, particularly those of emerging markets.

"The cult of equities did a lot of damage," Mr. Arnott says. "People are expecting the markets to do their saving for them by delivering a high return. That's just not realistic.

"Ratchet down your return expectations," he adds, "broaden the tool kit, and recognize that real returns are what matters."

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