Chart of the Month

May 2018

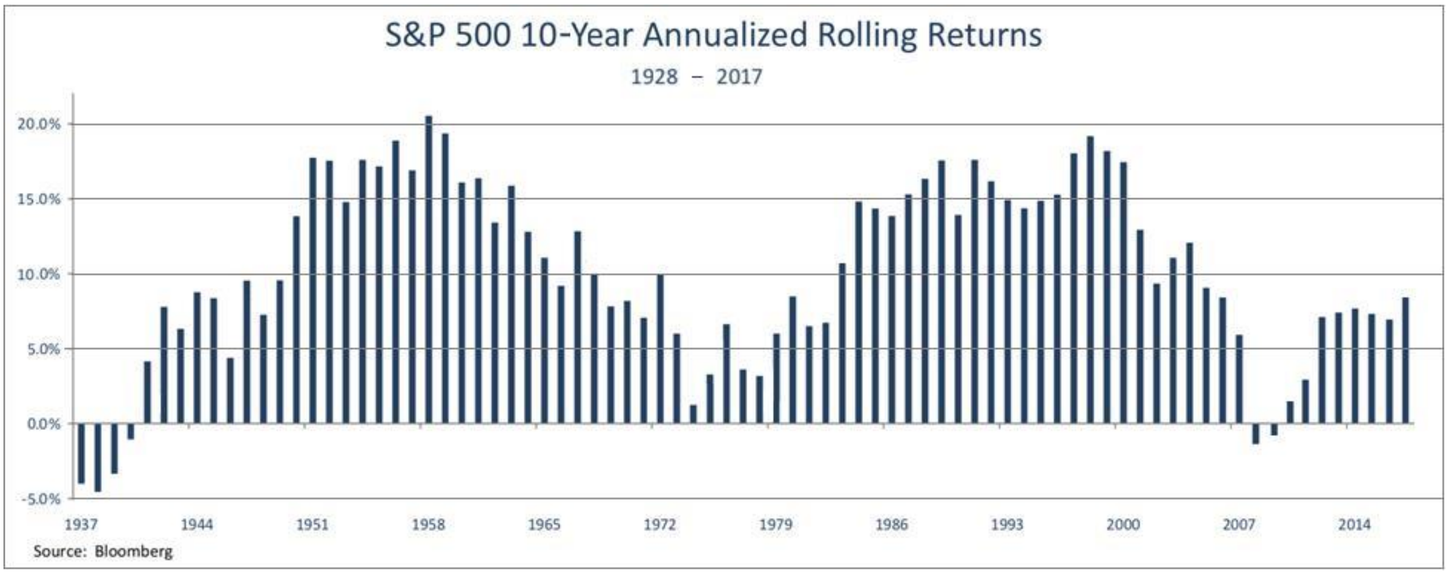
The chart below displays the 10-year annualized rolling returns for the S&P 500 from 1928-2017. Each bar indicates the compound average annual total return (capital appreciation or depreciation plus dividend yield) from the previous decade inclusive of the year presented. For example, the most recent 10-year annualized rolling return of 8.5% is based on the results from 2008 through 2017.

The average annual return has been approximately 10% with the number of observed periods split almost evenly above and below this norm. Nonetheless, the last 13 rolling 10-year periods have produced returns lower than the long-term average. With the “reversion to the mean” theory in mind, the 10-year annualized return will jump above the average by the end of this year simply by lopping off 2008 (when the S&P 500 fell 37%). A flat year in 2018, in fact, will cause the 10-year annualized rolling return to pop to 13.6%.

Of note, when the long-term average was breached on the upside in the prior two cycles, the subsequent 10-year annualized rolling returns remained above the mean for about two decades. However, even if the past is prologue, it does not suggest that the annual returns going forward will be at least 10% because the rolling periods over the next decade will benefit from the exceptional performance from 2009-2017, a period that generated positive results each and every year with a compound average annual return of more than 15%. In other words, the pendulum reversed course in 2009 and the 10-year rolling returns will reflect this fact when the calendar flips to 2019.

While we remain optimistic about the economic and investment outlook for the foreseeable future, the math suggests that it will be difficult for the stock market to produce total returns equal to or greater than the long-term mean of 10%, largely due to the fact that the average dividend yield of the S&P 500 is currently less than 2% compared to an historic average of 4%. This differential of two percentage points should detract from the total returns by a like amount in the future. Furthermore, with the current P/E ratio slightly above the norm, it follows that the multiple is more likely to contract than expand over time, particularly in a rising interest-rate environment.

The combination of a lower dividend yield and a higher P/E ratio should serve to reduce the expected returns from the long-term average of 10% to perhaps 6%-7%. The good news is that stocks should continue to offer competitive returns vs. alternative investments such as bonds, cash, and even real estate. In addition, with inflation in the low-single digits, investors are likely to earn positive real rates of returns, allowing them to outpace the cost of living.



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