Portfolio strategy: Ken Fisher

Forbe's Magazine's Portfolio Strategy columnist and Fisher Investments chief executive KEN FISHER says that academic predictions of long-term equity returns tell us only that academic predictions are always bearish and always wrong

Smarter than the average bear? I don't think so

It has become fashionable to latch on to the equity risk premium (ERP) as a justification for being bearish, which is very sophisticated – and very false. The ERP gets its basis correctly enough in theory but its usage to predict is worse than questionable.

The theory of the ERP is that stock investors need a return above that of short or long-term government bonds to justify the added risk of owning stocks. Fair enough. In the very long term, stock returns have averaged about 5% a year better than bonds or cash and that spread is basically the equity risk premium. The problem begins when we look forward.

Theory tells us nothing about a particularly right way to calculate the ERP. Academics use a variety of ways with formulas of their choosing. They all sound sophisticated, reasonable and are always low. Academics are always dismal. Always have been. Most today calculate the ERP at about 3%. Adding that to a 4% bond implies stocks' long-term future return might be about 7%, which is markedly below long-term history and not terribly appealing. From there come the arguments that stocks will disappoint for a decade or more.

This is all nonsense. Yes, they all figure a low ERP right now. But if you backtest the very same formula they were invariably lower 10 and 20 years ago. Since stocks fared so very well over those decades and the ERP missed it, why should ERP now foresee our future any better.?

Consider history, both in the UK and the US. Take 10-year rolling periods.

Stock returns have had huge fluctuations from bond and cash returns. On both sides of the pond, stocks have sometimes had decades doing as much as 18% a year better than bonds and sometimes 5% worse.

Such big swings imply that this decade could easily be anywhere in that huge spread. Stock prices are always determined by shifts in supply and demand for securities. Not only are stocks more volatile than people think – as I detailed in both June and July – but, for the same reasons, so is the ERP.

What determines how stocks do this decade is not what we fret about and quantify now, but supply and demand shifts happening in 2010-2013. We can't begin to think that far ahead any more than the USSR's demise was widely seen five years beforehand. Or that 9/11 would occur.

Stocks may do 3% better than bonds in the next decade. Then all the academics will be right, plus those praying at their altar. But stocks could as easily do worse than bonds or cash – or do better by 10%, 15%, or 18% annually.

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Any of that is quite possible and normal looking back at history. That academics' ERP numbers come out low is simply a reflection of dismal assumptions – ones they see as reasonable. Said differently, to say you're bearish because your ERP estimate is low is the same as saying you're bearish because you're bearish.

I don't know what stocks will achieve in the next decade. But neither do they. Nor you. We're all entitled to our guess but it is no more realistic than that. If you think you can forecast the important variables that will determine returns in the back half of this decade you are what behaviourists call heavily overconfident. What we can be confident in is that right now stocks are besting gilts and cash. With so many investors so dour it should pay for a bit longer to bet they're wrong.

Along the way enjoy some good stocks such as Allied Irish Banks (obviously from Ireland), or Dutch-based photolithography leader (used in making semiconductors) ASML Holdings. And Canadian electronics systems house ATI Technologies, whose products increase display speed on personal computers and are on fire right now. And Finnish machinery maker, Metso, which is about due for a bounce back. And Italian clothes retailer Benetton. And Japanese electronics maker TDK. Finally, you might try a package of US-based insurers such as Aon, Chubb, Hartford Insurance and Jefferson-Pilot. Their time comes soon after a very long wait. BM

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