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Jeremy Siegel: Stocks for the Long Run

How stocks have far outpaced other asset classes for the past two centuries

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In his investing classic, “Stocks for the Long Run,” Jeremy Siegel set out two goals: “To document the returns of major asset classes of financial assets over the past two centuries and to offer strategies that maximize long-term portfolio growth.”

Readers appear to have embraced those goals; there was enough demand to produce four more editions after the original appeared in 1994. The fifth edition, published in 2014, will be used as the source for the digesting of this book.

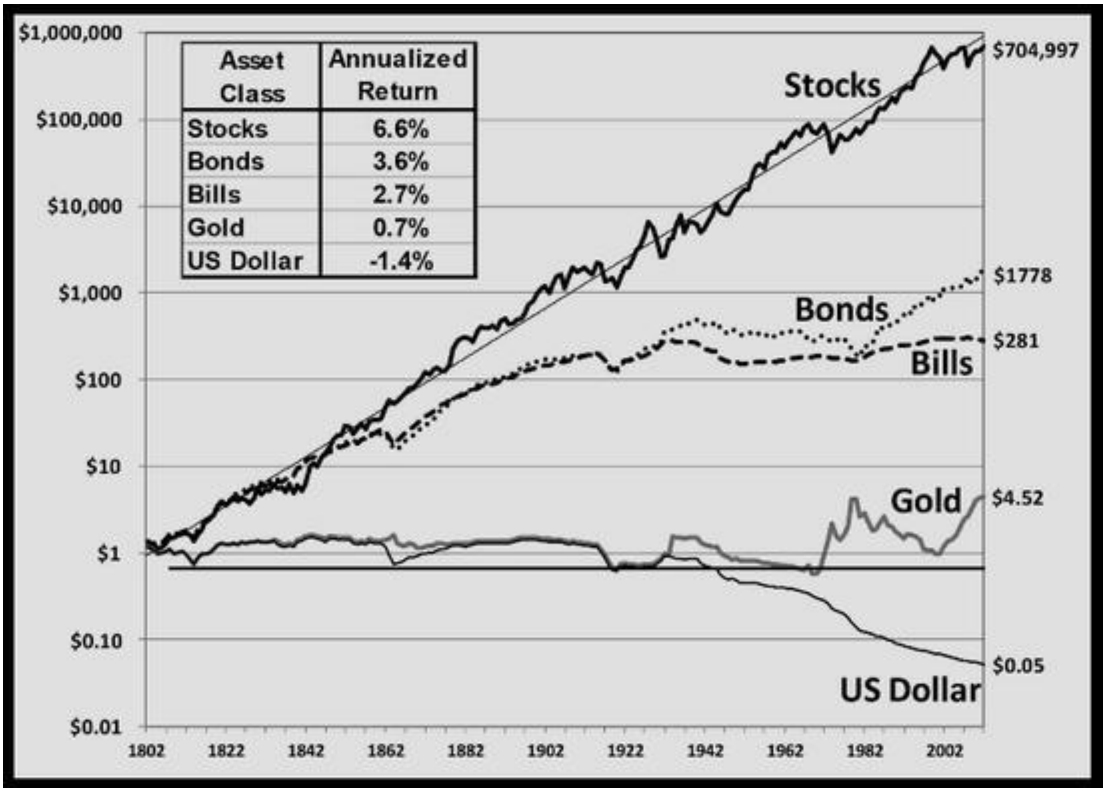
Chapter one, titled "The Case for Equity," has an overview of how certain asset classes had fared between 1802 and 2012. Those classes were:

1. Stocks.
2. Long-term government bonds.
3. U.S Treasury bills.
4. Gold.
5. U.S. currency.

All were evaluated with what is called the “total real returns” approach, meaning they include reinvestments from dividends (when available) as well as capitals gains or losses, and measured in terms of constant purchasing power.

The following chart from the book shows how each class has fared, after inflation, on a logarithmic scale. Each one shows the growth of one dollar invested between 1802 and 2012:

- [Warren Buffett Recent Buys]
- [Warren Buffett's Current Portfolio]
- [This Powerful Chart Made Peter Lynch 29% A Year For 13 Years]



Over the long run, the very long run, one dollar invested in U.S. currency in 1802 declined to just a nickel 210 years later, obviously a very poor investment. Gold did at least break even, delivering $4.52 in returns after 210 years, while Treasury bills returned $281 and bonds brought in $1,178. They were all overshadowed by stocks and equities, which brought in slightly more than $700,0i00 over the same period. Hence, the idea that stocks are the best asset choice for the long run.

The chart also shows the average annual gain in percentage terms over the 210 years:

- Stocks: 6.6%
- Bonds: 3.6%
- Treasury bills: 2.7%
- Gold: 0.7%
- U.S. dollar: -1.4%

Focusing specifically on stocks, Siegel noted this showing is the equivalent of owning a broadly diversified portfolio or an index fund. More importantly, it meant that purchasing power has doubled roughly every decade over the previous 210 years.

The author also wanted readers to appreciate the stability of real returns over such a long period: “The stability of real returns is striking; real stock returns in the 19th century do not differ appreciably from the real returns in the 20th century. Note that stocks fluctuate both below and above the trendline but eventually return to the trend.” This tendency to move back to the trendline is called “reversion to the mean.”

Of course, that does not hold in shorter terms, when volatility shows up because of factors such as interest rates, earnings, risk and uncertainty. Siegel also recognized psychological factors, including those all-time favorites, fear and greed. He added, “Yet these short-term swings in the market, which so preoccupy investors and the financial press, are insignificant compared with the broad upward movement in stock returns.”

In the second half of the chapter, Siegel provided a historical perspective on stocks as an investment. In the 19th century, he pointed out, stocks were considered material for speculation, not conservative investment. That changed in the early 20th century when the financial community recognized stocks might be good investments in certain economic circumstances.

For the first quarter of the 20th century, the investment community generally adopted Irving Fisher’s philosophy that stocks would be superior to bonds during inflationary years but underperform bonds during years of deflation (Fisher was a prominent American economist, a professor at Yale University and a successful investor).

That widespread belief was overturned by Edgar Lawrence Smith, a financial analyst and investment manager who did his own research on historical stock prices. According to Siegel, Smith was the first to show that a diversified portfolio of common stocks would outperform bonds when commodity prices were both rising and falling. Smith published this research in a 1925 book titled, “Common Stocks as Long-Term Investments.”

His ideas won widespread acclaim; praise came from, among many others, John Maynard Keynes, one of the 20th century’s most famous economists, and even from Fisher, who revised his earlier thinking.

While Smith’s book might have brought stocks to mainstream acceptance, the stock market crash of 1929 and the subsequent Great Depression turned many investors away from stocks for years, if not lifetimes. Among those trashing Smith’s theory in the 1930s were Benjamin Graham and David Dodd, authors of the value investing bible, “Security Analysis.”

In the years after World War II, a number of prominent analysts and academics came out with studies showing that stocks could be conservative, non-speculative investments. But what really brought back investors was the bull run between 1982 and 2000, a run which saw stocks rise more than tenfold in less than two decades. In the 1990s, stocks also benefited as Communism collapsed in the Soviet Union and Eastern Europe, and money could be shifted from the military to domestic consumption.

While a few observers warned of potential danger in the second half of the decade, the investment community went into a form of overdrive. This was happening, in large part, because of technology stocks and Internet stocks, which were exploding in popularity. But it was a bubble; on March 10, 2000, the bubble topped out and stock prices began collapsing. Among the biggest losers were the S&P 500, down 48.2%, the Nasdaq, which fell by 78%, and the dot-com index, which plunged an astonishing 95%.

Yet, a couple of years later, enthusiasm for stocks returned. As Siegel pointed out, the market nearly doubled in five years, from 7,286 on Oct. 9, 2002 to 14,165 on Oct. 9, 2007.

As we know now, troubles were brewing in the real estate and financial sectors, which began showing up in 2006. Still, those problems got little attention until big financial institutions began taking serious and in some cases fatal hits in 2008.

Over the course of more than 200 years, then, stocks have steadily risen, completely outpacing other asset classes. In the shorter term, though, there are many dramatic ups and downs, as we've seen from the history of just the past 100 years.

(This article is one in a series of chapter-by-chapter digests. To read more, and digests of other important investing books, go to this page.)

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About the author:

Robert Abbott
Robert F. Abbott has been investing his family's accounts since 1995 and in 2010 added options -- mainly covered calls and collars with long stocks.

He is a freelance writer, and his projects include a website that provides information for new and intermediate-level mutual fund investors (whatisamutualfund.com).

As a writer and publisher, Abbott also explores how the middle class has come to own big business through pension funds and mutual funds, what management guru Peter Drucker called the "unseen revolution."

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