

Monetary Trends



What Can “Buy-and-Hold” Stock Investors Expect?

The total nominal return on stocks (column 1 in the table) is the sum of the average dividend yield and capital gains, or price appreciation (columns 2 and 3, respectively). Annualized after-inflation (“real”) total returns on U.S. stocks—obtained by subtracting column 5 from column 1—were 7.5 percent between 1926 and 1997. For comparison, annual real total returns on short-term government securities were only 0.6 over this period.

What returns should investors expect from stocks in the future? Relatively high long-term returns on stocks in the past do not necessarily portend high future returns—particularly now. The dividend yield on the S&P 500 index was 1.2 percent in April 1999, the lowest ever recorded and far below either the 4.6 percent average for the period 1926-1997 or the 5.4 percent average for the period 1802-1997.* As for capital gains, stock prices tend to track GDP over time, as a comparison of columns 3 and 4 indicates. Thus, GDP forecasts are a critical input for making long-run capital-gains forecasts. Real GDP growth is likely to average 2 to 3 percent annually and current inflation expectations are also 2 to 3 percent. This adds up to a forecast of 4 to 6 percent annual nominal GDP growth, somewhat below the rates shown in column 4. Thus, with extremely low dividend yields and moderate expected GDP growth, one should probably expect total nominal returns on stocks to average no more than 5 to 7 percent in the future.

For “buy-and-hold-forever” investors—those who may add to but never sell off their portfolios completely—there is a second important reason to expect returns

far below the misleading historical total-return statistics given in the table. Examples of buy-and-hold-forever investors include endowment or pension funds, some family trust funds, or a government trust fund such as Social Security. All have theoretically unlimited investment horizons, so they may never sell off their portfolios altogether. For them, income consists mainly of dividends and interest, even if some securities are sold to generate income periodically. In a nutshell, these investors probably should ignore the capital gains component of total returns because these gains are available only if an investor sells out of the market, at least temporarily, in order to lock in a capital gain. Given that buy-and-hold-forever investors can only be out of the market temporarily—otherwise, they would give up the equity risk premium forever—realizing capital gains implies a risky strategy of attempting to time the market. Few investors can do this consistently well.

The unavoidable implication of low current dividend yields and low expected nominal GDP growth is that stock investors of all kinds may be forced to accept historically subpar total returns in the future. Given the likely unimportance of capital gains for buy-and-hold-forever investors, unprecedentedly low current dividend yields mean that endowments and other perpetual investors in stocks can expect little more than a trickle of true cash returns.

—William R. Emmons

Holding Period	(1) Total nominal return on stocks	(2) Return due to dividends paid to stockholders	(3) Return due to price appreciation	(4) Nominal GDP	(5) Consumer price inflation
1926-1997	10.6	4.6	6.0	6.4	3.1
1946-1997	12.2	4.3	7.9	7.3	4.3
1966-1997	11.5	3.9	7.6	7.8	5.2

All returns are annually compounded percentage rates.

*Jeremy J. Siegel, *Stocks for the Long Run* (New York: McGraw-Hill, 1998), 2nd Edition, pp. 13, 15.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.

