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U.S. | JOURNAL REPORTS: YEAR IN REVIEW

Can the Stock Market's Big Gains Continue in the Years Ahead? Unlikely.

Investors need to have a more-sober, realistic expectation for future market returns

By Gregory Davis
Dec. 15, 2021 8:00 am ET

Despite the continuing pandemic and global jitters about everything from climate change to inflation, the good times have kept rolling in the markets during 2021. The U.S. stock market continued to soar across the board—large-cap, small-cap, growth, value—seemingly every segment of the stock market just kept going up.

But the past isn't prologue, so the question for investors is now: Can these good times last in the years ahead? In short, not likely. Given where the markets have been and where they are now, it's critical that investors have realistic expectations for future market returns.

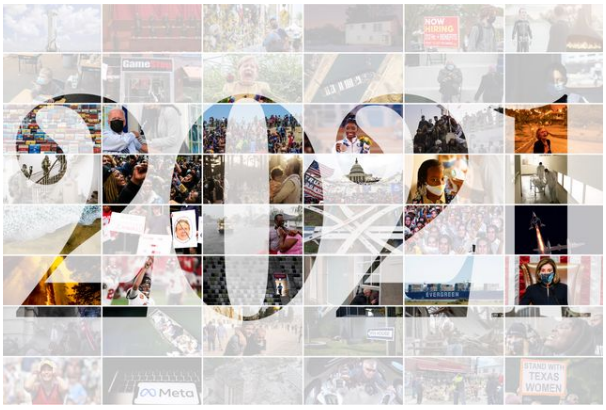
Consider the Dow Jones U.S. Total Stock Market Index. The broad U.S. market is up more than 24% year-to-date as of mid-December and nearly 17.5% annually over the past five years. Even over the past 10 years, the index is up more than 16% a year—all far above the long-term average annual returns of 9% to 10%. With market returns like these, it's easy for investors to anchor their expectations to such lofty heights.

But relying on such returns to continue indefinitely could prove to be a major mistake. Equity markets are facing headwinds, including: the continuing unpredictability of public health; an economic environment with inflation at its highest level since the early 1990s, driven largely by supply-chain constraints that, while transitory, have lasted longer than many expected; and U.S. growth continuing its reversion to the long-term trend of about 2% a year.

Corporate earnings

What would be needed for the breakneck pace of equity-market returns to continue? One ingredient would be extraordinary corporate earnings growth. However, over the long term, earnings tend to grow in line with the overall level of economic growth. And while it's possible for price-earnings multiples to continue expanding in the near term toward levels not seen since the dot-com bubble—as markets can remain irrational for extended periods—such expansion isn't a source of sustainable market returns.

YEAR IN REVIEW: 2021 »



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And then there is monetary policy. When the pandemic roiled markets in March 2020, the Federal Reserve took aggressive action. The Fed's unprecedented accommodative policy stabilized the markets, likely avoiding a prolonged economic crisis. While the pandemic was disruptive to all of us and had tragic consequences for far too many, the Fed played a significant role in preventing the worst possible outcomes from becoming reality.

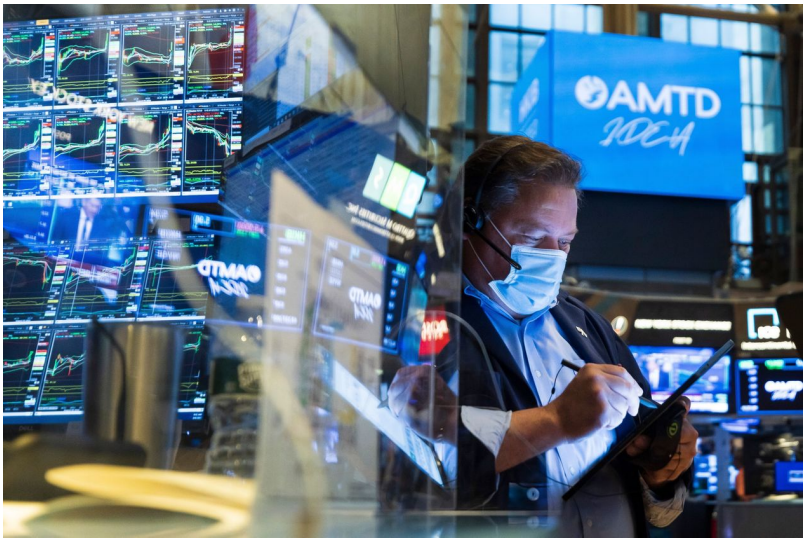
But when is enough, well, enough? The Fed kept its foot on the pedal for much of the past two years, leading to a number of distortions in both the equity and fixed-income markets. Nominal yields at the long end of the interest-rate curve are below 2%. With current inflation levels recently surpassing 6% and expectations for long-term inflation beginning to creep upward, the real, inflation-adjusted interest rate on 30-year Treasury bonds is negative.

How have investors responded to this market environment? Remarkably well. Many of the trends we've seen in investing over the past several years persisted in 2021. Investors continued to choose low-cost, passively managed ETFs over high-

cost active management.

In fact, 2021 has been a record-breaking year for ETFs. Net cash flows into U.S.-listed ETFs exceeded $700 billion through October. These cash flows shattered the previous annual record of $510 billion into ETFs set last year, with two months still to go. Digging a layer deeper, the cash flows are going into the right places —low-cost, broadly diversified funds that provide exposure to the broad equity and fixed-income markets.

Further, the data suggest that investors aren't merely chasing returns. Even with the strong equity-market returns, investors' net cash flows into fixed-income funds exceeded equity cash flows by more than $160 billion, despite negative returns on the broad U.S. fixed-income market. This suggests that investors are rebalancing their portfolios to maintain appropriate risk postures.



A floor trader at the NYSE. Vanguard's Mr. Davis says equity markets are facing headwinds, including the pandemic and inflation.

PHOTO: JUSTIN LANE/EPA/SHUTTERSTOCK

What to expect

So, what kinds of returns should investors expect? Our model suggests that forward-looking nominal annual returns for U.S. equities over the next 10 years are likely to be between 2% and 4%, with inflation predicted to come in at 1.5% to 2.5%. With valuations for non-U.S. equities lower than the U.S. market, we see more upside on international stocks in the years ahead. (We present our expectations for future long-term returns as a range of potential outcomes rather

than a point estimate, to treat the future with the respect it deserves.)

For fixed income, we expect future nominal annual returns over the coming decade to be in the 1% to 2% range. Given today's persistent low-yield environment, it's difficult to expect much more from bonds. Yet, despite muted return expectations, bonds continue to play an important role in investors' portfolios. Bonds typically offer relative stability when the equity markets are volatile—an anchor to windward on choppy seas.

For fixed-income investors with long-term time horizons, rising interest rates can lead to higher total returns. When interest rates increase, cash flows from bond coupon and principal payments are reinvested at higher rates, increasing the yield component of future total returns. The higher yields on reinvested cash flows can outweigh the short-term market decline over the long term for investors who plan to maintain their positions for longer than their bond portfolio's duration.

Given this investment landscape, how should you position your portfolio for the years ahead? First and foremost, focus on the factors you can control. Be thoughtful and realistic about your investment goals. Ensure that investment success doesn't depend on unrealistic expectations for market returns or impractical saving or spending requirements.

Keep investment costs low, because the lower your costs, the greater your share of your investments' returns. And take advantage of opportunities to maximize tax efficiency, such as saving in an employer-sponsored retirement plan or IRA.

Build your portfolio with broadly diversified mutual funds and ETFs that offer exposure to global stocks and bonds. Ensure that your asset allocation is appropriate for your unique circumstances and tolerance for risk.

Above all, stick to your plan. The ups and downs of the markets can cause even the most seasoned professional investor to react impulsively. Working with a trusted adviser can help you stay on track. Try to tune out the noise and stay focused on your long-term goals. Put simply, stay the course.

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Appeared in the December 16, 2021, print edition as 'Investors, Back to Earth.'

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