Stocks Tarnished
By 'Lost Decade'

U.S. Shares in Longest Funk Since 1970s; Credit Crunch Could Prolong Weakness

By E.S. BROWNING
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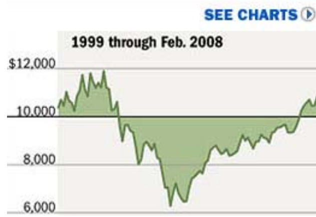
Over the past 200 years, the stock market's steady upward march occasionally has been disrupted for long stretches, most recently during the Great Depression and the inflation-plagued 1970s. The current market turmoil suggests that we may be in another lost decade.

The stock market is trading right where it was nine years ago. Stocks, long touted as the best investment for the long term, have been one of the worst investments over the nine-year period, trounced even by lowly Treasury bonds.



A look at stocks during downturns

The Standard & Poor's 500-stock index, the basis for about half of the $1 trillion invested in U.S. index funds, finished at 1352.99 on Tuesday, below the 1362.80 it hit in April 1999. When dividends and inflation are factored into returns, the S&P 500 has risen an average of just 1.3% a year over the past 10 years, well below the historical norm, according to Morningstar Inc. For the past nine years, it has fallen 0.37% a year, and for the past eight, it is off 1.4% a year. In light of the current wobbly market, some economists and market analysts worry that the era of disappointing returns may not be over.

Until last fall, many investors had viewed the bursting of the tech-stock bubble as a nasty but short-term setback. The market had resumed its upward march, reaching new highs in October.

Then the credit crisis began weighing on stocks, as did the possibility of a recession. By March 10, the S&P 500 was down 18.6% from its Oct. 9 record close, nearing the 20% decline that signals a bear market. It has rebounded since then amid the Federal Reserve's efforts to stabilize the financial system, but it remains 13.3% below its October record.

Conventional stock-market wisdom holds that if investors buy a broad range of stocks and hold them, they will do better than they would in other investments. But that rule hasn't held up for stocks bought in the late 1990s or 2000.

Over the past nine years, the S&P 500 is the worst-performing of nine different investment vehicles tracked by Morningstar, including commodities, real-estate investment trusts, gold and foreign stocks. Big U.S. stocks were outrun even by Treasury bonds, which historically perform much less well than stocks. Adjusted for inflation, Treasurys are up 4.7% a year over the past nine years, and up 5.8% a year since the March 2000 stock peak. An index of commodities has shown about twice the annual gains of bonds, as have real-estate investment trusts.

Stocks also underperformed other investments during the 1930s and the 1970s. During both of those periods, stocks would rally strongly, only to fade. It took well over a decade in each case for stocks to move lastingly upward.

Righting the Ship

So far, the current decade hasn't featured the high inflation of the 1970s or the high unemployment of the 1930s. That makes some analysts and economists hopeful that the stock troubles won't be as bad or last as long as they did back then, despite the housing crisis and the breakdown in parts of the mortgage and lending businesses. Many of them hope that the Federal Reserve will do a better job of righting the ship than it did in those prior decades.

Finance professor Jeremy Siegel at the University of Pennsylvania's Wharton School has written about stock behavior back into the 19th century. During the past decade, he points out, the worst years were from 2000 through 2002, when stocks fell sharply. Although the S&P 500 has been inconsistent since then -- rising strongly in 2003, then registering single-digit gains in 2004, 2005 and 2007 -- he considers the bad times largely past. Other optimists agree.

IN A RUT

- **The Situation:** By one broad measure, the stock market has made no lasting gains over the past nine years.
- **The Background:** Through history, lengthy stock booms have typically been followed by busts that can last a decade or more.
- **What's Next:** Some economists believe that current economic troubles are severe enough that the period of stock weakness isn't over.

The Pessimistic View

But Yale economist Robert Shiller, who predicted the market trouble in his 2000 book "Irrational Exuberance," warns that the market still hasn't shaken off its excesses. He and some other analysts think the latest volatility is a symptom of more trouble to come.

"I have to say that this isn't a great time to be in the stock market," says Prof. Shiller. "The housing crisis that we are going through is going to put a damper on the economy that is longer than a recession. I don't see the stock troubles ending as quickly as many people are imagining."

Historically, stocks rise about two years out of every three, for an average gain of 7% a year when controlled for inflation, according to Prof. Siegel. Stocks have shown gains for almost every 10-year period since 1925 -- 98.6% of the time, according to Ned Davis Research.

But when stock investing becomes a mania, as it did in the 1920s, the 1960s and the 1990s, it leads to prolonged periods of subpar performance, according to financial historian Richard Sylla of New York University's Stern School of Business.

Prof. Sylla has examined stock booms and busts back to 1800. He found periods of exceptional strength in the late 1810s and early 1820s, the 1840s, the 1860s and the early 1900s. Those periods were followed by lengthy weakness in the 1830s, the 1850s, the 1870s and before 1920. In a 2001 paper, he forecast a 10-year period of stock weakness.

"When you have extraordinary returns, as we did from 1982 through 1999, then usually the next 10 years aren't very good," says Prof. Sylla. His research suggests that exceptional booms steal gains from the future. When the booms end, returns become subpar, so that average returns over the longer term fall back to the 7% norm. Economists call this "reversion to the mean," the idea that exceptional performance can't last forever.

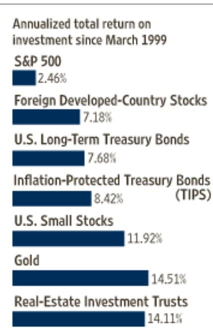
Bullish investors believed that the bad days were over late in 2002, when stocks rebounded following the technology-stock wreck, the Sept. 11 terrorist attacks and the collapse of Enron Corp.

The S&P 500 rose 26% in 2003, amid hopes for a quick victory in Iraq. In 2004, the S&P 500 rose only 9%. It was up 3% in 2005, 14% in 2006 and 3.5% in 2007. The index is down 7.9% so far this year. Those numbers are not adjusted for inflation, which would lower annual returns by a few percentage points.

The Dow Jones Industrial Average, which had fewer technology stocks than the S&P 500 and suffered less in the bear market from 2000 to 2002, has held up better, but not a lot better. It has risen less than 1% a year since January 2000.

Role of Individuals

Prof. Sylla expects to see stocks turn more lastingly upward some time in the next two years. The market's direction will depend partly on the individual investor. The 1990s stock bubble and the bear market that followed came at a time when more individuals were managing their own retirement savings through 401(k) accounts, individual retirement accounts and the like.



Individual investors helped create bubbles in the markets for technology stocks and for real estate. In recent years, investors have been putting far less money into U.S. stocks than they did during the stock-investing boom. In 2000, at the height of that boom, Americans added $260 billion to U.S.-stock mutual funds, according to the Investment Company Institute, a trade group. Last year, investors took more money out of those funds than they put in -- a net outflow of $46.4 billion.

America's shift toward self-managed retirement could soften some of the stock-market volatility. People appear to be much less likely to move money around in retirement accounts than in other investment accounts, according to economist John Ameriks at mutual-fund company Vanguard Group.

Many 401(k) participants leave their allocations alone for long periods of time, says Mr. Ameriks. If they set up their accounts to send money into stocks each month, those accounts tend to keep doing so through bull and bear markets alike. That may provide some support to stocks. Some investment advisers say passive contributions like that actually make some sense. People whose retirement accounts have bought stocks each month, year in and year out, haven't done nearly as badly as those who bought in the late 1990s and stopped buying, Prof. Sylla says. While the S&P 500 is down since 1999, it is up since mid-2001, meaning that most stock purchased since then by retirement accounts shows a gain.

Stock Fundamentals

A big problem for the market right now is what analysts call stock fundamentals. Strong corporate-profit gains and low inflation have

supported stocks since 2002, but they are becoming harder to sustain.

In a typical year, Prof. Sylla says, corporate profits run at about 5% or 6% of total economic output, after tax. In 2006, that number was 9%, a record. Historically, this number tends to revert to the mean, suggesting that profits now could weaken. "Profits may fall to 3% or 4%" of economic output, Prof. Sylla says.

Spending by ordinary people could have an effect on those profits. Consumer borrowing and spending kept the economy afloat after the stock bubble popped in 2000. Emboldened by high home values, people borrowed at levels rarely seen, pushing down the national savings rate to zero.

That's what worries Prof. Shiller. After studying the housing market, he sees home values continuing to weaken for years. He expects consumers to borrow and spend less, and to rebuild their savings.

A consumer pullback would hold back economic growth and corporate profits, putting a damper on U.S. stock gains and giving investors an incentive to continue putting money into commodities or stocks in Brazil, Russia, India and China. Baby boomers concerned about retirement income could look for safer investments with guaranteed returns, such as Treasury bonds and bond-like products offered by mutual-fund companies.

On the Horizon

"We have to accept that this is no longer a nation of 4% real economic growth. This is a mature nation that no longer has a strong manufacturing base," says Steve Leuthold, chairman of Leuthold Weeden Research in Minneapolis. He believes that another bull market is on the horizon, perhaps following some additional stock declines. But that future bull market, he contends, could be followed by another bear market that could bring stocks back close to where they are today.

Before another lengthy bull run can begin, stocks need to overcome two problems: the hangover from the high prices of the late 1990s, and the continuing effects of the exceptionally low interest rates instituted by the Federal Reserve in 2001 and again today. Those low interest rates helped push corporate profits higher, but also fueled borrowing excesses that led to today's economic problems.

To some analysts, stock prices still look inflated. Prof. Shiller calculates that the S&P 500 traded in the late 1990s at more than 40 times its component companies' profits -- far above the historical norm of 16. (To avoid distortions, he uses average profits over a 10-year period.) Today, the S&P 500 still trades at more than 20 times profits -- still far above average.

"The S&P 500 never got back down to its long-term trend line" after the 1990s, says Jeremy Grantham of Boston money-management firm Grantham, Mayo, Van Otterloo & Co. Mr. Grantham, who has long warned of a prolonged period of subpar stock performance, says exceptionally low interest rates temporarily propped up the indexes.

There are reasons to hope that things won't be as ugly this time as they were either in the 1970s or in the 1990s in Japan, which went into a prolonged slump after bubbles in its housing and stock markets.

For one thing, although inflation has been running above 4% this year, it remains well below the double-digit rates of the 1970s. That's made it easier for the Fed to stimulate the economy without worrying about sparking runaway inflation.

One big question is how much worse investor confidence will get. The bearish Mr. Grantham expects investors to become gloomier, but not as pessimistic as they were during past bad stretches.

"I think the global economy will stay, on balance, not so bad," he says. "There is no reason for people to become as pessimistic as they did even in Japan, and certainly not as pessimistic as in the Depression."

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