

How Long Can You Run?

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The long run is a dominant feature of institutional investing, but I confess it leaves me cold. The long run reminds me of seatbelt risk—that people drive more recklessly because they have their seatbelts fastened. Investors often take on more risk than they should because in the long run there appears to be no risk in equity ownership.

Yes, equity instruments must provide the highest rate of return in the very long run. Our system cannot survive if investors who take the greater risk earn less than investors who take smaller risks—owners versus creditors, for example. But then I am reminded of Keynes's famous aphorism:

The long run is a misleading guide to current affairs. In the long run, we are all dead. Economists set themselves too easy, too useless a task if in the tempestuous seasons they can only tell us that when the storm is long past the ocean will be flat.

Indeed, what do we mean when we say “in the long run”? How long is that? As I observe the world of investing, the long run is a matter of taste, a highly elastic concept whose limits will vary depending on what someone is trying to prove. A wonderful recent book, *Triumph of the Optimists*, by Elroy Dimson, Paul Marsh, and Mike Staunton (Princeton University Press, 2002), launches the long run in 1900. Jeremy Siegel's long run reaches back to 1802. Robert Shiller begins with 1871, while Roger Ibbotson favors 1926. For many practitioners, ten years is a long enough run, but living through even five takes fortitude.

We must remember that the long run keeps getting longer, day by day. The vantage point for viewing the past from yesterday was not the same as the perspective from today. In 1900, investors could look back over a century

when bonds averaged an annual return of 5.1% with only five negative returns, while stocks earned 7.0% but with a standard deviation of 15.3%. Even if the early data are flakey, the contrast is vivid enough.

No investor looking back over that long run could possibly conceive of what the view of the past would be for their followers viewing the even longer run of 200 years. By 2002, stocks had scored a 200-year average return of 9.3% with a standard deviation of 17.6%, while bonds fell far behind with a 5.3% return, a standard deviation of 7.5%, and 30 years of negative returns.

Or consider the history of the equity risk premium—the spread between large-cap equity returns and long-term Treasury bonds—over the two 100-year spans from 1802 to 1902 and from 1902 to 2002. Those are a couple of long runs for you!

If you had gone short bonds and long stocks in 1802, your investment over the next hundred years would have grown 3.3 times, or 1.2% a year. Was that enough excess return to justify making equities the major share of your portfolio in the tempestuous seasons? The same strategy from 1902 to 2002 would have produced a risk premium that multiplied your original investment nearly 60 times, or 4.2% a year (if we pick 1999 instead of 2002, the multiple rises to 162 and the growth rate to 5.4%). No wonder we invest differently from the way our great-great grandparents did it.

If you believe the long run is shorter than a hundred years, try the last two 26-year spans, from 1950 to 1976 and 1976 to 2002. Despite the huge bull market since 1982, the annual risk premium in the past 26 years averaged less than a third of the whopping 10.3% average annual excess return for 1950–1976, when bonds were certificates of confiscation.

Which run is the long run? I do not know.