Stocks for the Really Long Term

The Motley Fool
By Robert Brokamp

The following is adapted from the February issue of Rule Your Retirement. Take a 30-day free trial today and receive a complimentary copy of our bestselling book, Money After 40.

I love to cite Jeremy Siegel's Stocks for the Long Run. I love pointing out that from 1802 to 2001, stocks had a compounded annual return of 10.2%, compared with 4.9% for long-term bonds. Or that stocks have outperformed bonds in 61% of all one-year holding periods, 70.9% of five-year periods, 82.4% of 10-year holding periods, 95.4% of 20-year periods, and 100% of 30-year periods.

Or that even if investors had put in their money at the top of seven of the 20th century's major market peaks, they still would have made more in stocks than bonds, on average, over the subsequent 10-year period. They would have made twice as much in stocks than bonds over the following 20 years. And they would have made four times as much over the following 30 years.

That's important stuff to remember, especially if you think (as many of us do) that the market is, at best, fairly valued right now. Siegel argues that regardless of the market's valuation, investors who can hold on for the long term should come out on top. Siegel looks specifically at one notorious "bubble" and the darlings at the time, and he concludes that the seemingly overvalued stocks were actually reasonably priced. Let's step back 30 years and see what lessons there are today.

The Nifty 50
Back in the early 1970s, a group of stocks became known as "one-decision" stocks — companies you could buy and hold forever, regardless of their price. These large-cap, high-P/E stocks were world leaders — companies such as **IBM** (NYSE: IBM), **Coca-Cola** (NYSE: KO), **McDonald's** (NYSE: MCD), and (of course) Chesebrough Ponds. Collectively, they became known as the Nifty 50. As a group, they had a P/E of 41.9, more than twice that of the 18.9 P/E of the Standard & Poor's 500.

By the mid-'70s, these one-decision stocks seemed like bad-decision stocks. While the S&P 500 dropped 48% in the 1973-1974 bear market, the Nifty 50 lost an average 62%. In a span of two years, **Xerox** (NYSE: XRX) dropped 71%, Avon fell 86%, and Polaroid — which had the highest P/E of the lot — lost 91%.

But get this: Siegel argues that those who invested in the Nifty 50 at the end of 1972 did just fine. Why? Because almost 30 years later, those stocks returned an average 11.6%, barely losing out to the S&P 500's 12.1%.

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The long-term mind-set

Clearly, according to Siegel, the decision to invest in stocks depends on whether you'll beat bonds and whether you'll match the index. The question is not whether your stocks will drop in the future, but whether at the end of your holding period (when you need to turn those investments into cash), you have been better off in stocks than any other investment.

But he doesn't suggest that investors should ignore valuation. In fact, he points out that the 25 stocks with the lowest P/E ratios posted an annual average return that was three percentage points higher than the return on the 25 stocks with the highest P/Es. Almost half of the stocks with the lowest P/Es beat the market, a feat accomplished by just six of the highest-P/E stocks.

The Fool's rules for asset allocation

Many people who did not follow a well-designed asset-allocation strategy and instead chased overvalued tech stocks in the late 1990s lost most of their invested capital. That is exactly why we dedicated a whole area of the *Rule Your Retirement* website to asset allocation. One of our rules: Always own stocks. Because you don't know the exact date at which you'll no longer need your portfolio, you must maintain a long investment horizon, regardless of your age. At 114, Verona Johnston was the oldest living American until she died last month. She graduated from college in 1912. Her father was a Civil War veteran. Now that's long-term.

But that doesn't mean you should buy just any stock. For all their lofty valuations, the stocks in the Nifty 50 couldn't beat the S&P 500. So why pay for market performance when you can buy an index fund and reduce the volatility of your portfolio? And, of course, you have to hold on, through thick and thin. Siegel says the Nifty 50 stocks were worth the prices paid. But for that to be true, investors would have to have held the stocks for 30 years and not become disheartened as stocks fell more than 60%. Investors who bought those stocks in 1972 had to wait nine years before the shares returned to their original value. If you intend to hold on for 20 years but get scared out of the market, you've cut your holding period short.

Finally, it should be noted that this applies to the broad market. When it comes to individual stocks, it may work out better or worse. Some stocks — such as ***Pfizer*** (NYSE: PFE), **PepsiCo** (NYSE: PEP), and **General Electric** (NYSE: GE) — beat the market an average three percentage points a year. Yet others barely budged. Pity the poor Xerox investors, who earned an average 0.15% a year for almost three decades. It would be very difficult to retire with that kind of return.

Robert Brokamp, who owns none of the companies mentioned in this article, is the editor of the Rule Your Retirement newsletter service. You can view the Fool's rules for asset allocation by taking a 30-day free trial. The Motley Fool is investors writing for investors.

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