

Caution: Possible Retirement Disasters Ahead

The recent market rally may have lulled investors into a false sense of security. But a study of long-term returns indicates Americans should start saving a lot more money.

By Brett Arends, The Wall Street Journal – November 02, 2010

Don't let the rally in the stock and bond markets fool you. Many Americans are still hurtling toward retirement disasters. Few realize it. Even many of those running the big pension funds don't know.

That's the conclusion of John West and Rob Arnott at Research Affiliates, an investment management firm in Newport Beach, Calif. In their latest report, "Hope Is Not a Strategy" they have some numbers to back it up.

"I worry a lot about people reaching their golden years and discovering, 'Oh, I should've saved more,' and 'Oh, I don't qualify for Social Security anymore because it's means-tested'," says Arnott, a widely respected market strategist. "We're headed for a retirement train wreck," he adds, "and it's going to get really ugly over the next 15 years."

Alarmist? Perhaps. But follow the math.

The returns you will get from your stock funds can come from only four things, West and Arnott note: dividends, earnings growth, inflation and changes in valuation.

Right now the dividend yield on U.S. stocks is about 2.2%, they note. Historically, earnings have grown by a surprisingly low 1% a year in real, inflation-adjusted terms. Arnott tells me the average since 1900 is only about 1.2% and in the past half-century just 0.6%. Will we get more in the future? With the U.S. population aging and heavily in debt? It's hard to imagine. Throw in a 2% inflation forecast -- more on this later -- and Research Affiliates forecasts a long-term return of 5.2%.

What about changes in valuation? Some generations are lucky. They invest in the stock market when it's depressed and shares are cheap in relation to earnings. This was the case in the 1930s and the 1970s. Then they retire and cash out when the market is booming and shares are expensive in relation to earnings, such as in the 1960s and 1990s. People today are not so lucky.

The stock market's latest rally has lifted shares already to pretty high levels in relation to average cyclically adjusted earnings. This so-called Shiller P/E (named after Yale professor Robert Shiller, who popularized the notion) has been an excellent indicator of market value. Right now it's around 22 -- well above its historical average of 16. The only time the market has boomed from these levels was in the late-1990s bubble, an atypical moment unlikely to be repeated anytime soon.

Roubini predicts 'fiscal train wreck'

Now look at bonds. Thanks to the recent boom, the picture for investors here looks even worse. And there is less room for ambiguity, because bond coupons and the repayment of principal are fixed.

Based on the yields of prices across all investment grade bonds, West and Arnott calculate likely long-term bond returns from here of about 2.5%. So an investor with 60% of his portfolio in stocks and 40% in bonds, a standard, if conservative, allocation, can expect a weighted average return from here of only about 4.1%. To put this in context, they notice that the typical big pension fund is still expecting to earn about 7% to 8% a year.

When you strip out 2% inflation, that means pension fund managers are expecting 5% to 6% percent a year in real, inflation-adjusted terms. But by West and Arnott's numbers, investors can expect only about 2.1%. Gulp.

Here's what this means for you:

- Someone who saves \$10,000 a year for 30 years and invests the money at 5.5% a year will end up with \$760,000.
- Someone who manages to earn only 2.5% on those investments will amass just \$420,000.

If you're running a pension fund, this kind of shortfall leads to a funding gap that must be made up by the plan sponsor. For a private investor trying to build his or her own savings, it leads to a dismal retirement.

Is there any hope? I asked Arnott about two possible sources of higher returns.

The first: stock buybacks. Will they help? Many companies are trying to return more money to investors, on top of dividends, by buying back stock. In theory, at least, this ought to boost returns, because it reduces the number of shares, increasing the value of those that remain. But Arnott cautions against relying on it.

We don't know how big these buybacks will be, and we don't know if they're sustainable, he says. Furthermore, the gains are usually offset by the issue of new stock and options to management. "Most buybacks are done to facilitate the exercise of management stock options," he says. The second possible source of better returns: emerging markets. Investors have been throwing money into emerging-market funds recently like a Hail Mary pass -- a last, desperate bid to snatch a decent retirement from the jaws of defeat.

But they may be substituting hope for reason. By Arnott's math, even the most heroic calculations cannot plausibly predict that earnings growth in emerging markets will be more than a couple of percentage points faster than in developed countries. And there are plenty of people who argue it won't be markedly higher, over time. Why? Where economies grow more quickly, new capital flows in. Current investors find their returns diluted by new enterprises and new stockholders.

Meanwhile, look at the valuations. Stock markets in emerging economies have skyrocketed in the past two years. Hot markets like Brazil and India have nearly recovered their 2007 manic peaks. As a result, your dividend income is even worse than in the United States. The yield on the Indian stock market is down to about 1%, according to FactSet Research Systems. Brazil has dipped below 2% and China 1.6%.

Bottom line? Neither pension funds nor private investors seem to have fully absorbed the grim lessons of the past decade. Returns are going to be much lower. People need to save more, much more, for their retirement. If the market rally this year has given them false hope, it will have turned out to be a curse more than a blessing.