Date - October 21, 2010

QUESTION: "Can you give me your comments on the article "The Great Stock Myth", by Megan McArdle, published in the Atlantic Monthly September 2010 magazine. I would like to hear your thoughts."

Jack

ANSWER:

Jack,

I finally had time to read the article you sent to me titled "The Great Stock Myth", written by Megan McArdle. Its premise – that there is a relationship between the risk-free rate of return and the expected rate of return derived from investing in the stock market – seems quite disconnected from the reality of the market. What makes the stock market value grow? Corporate earnings? "Expected" corporate earnings? Inflation? "Investor expectations" of long term growth in value? Dividends? The relationship between dividend earnings and the risk-free rate of return?
Perhaps investor expectations are the real "Myth" of investing.

Essentially, the writer is saying that long term expected growth in the stock market is really a myth - and an irrational one at that! At the very least, what she is saying is that it is financial foolishness to base State and Federal forward commitments - to pay pensions and social security - on this expectation that the stock market will grow at any particular rate of return. With this last statement, I certainly agree! In fact, many investors have gotten so familiar with the academic work, based on historical performance of the stock market over the past 60-80 years - that suggests that stock market returns are predictable - that they are willing to accept the premise that future rates of return are predictable.

Certainly, there is a "random walk" upward in the value of the stock market, if for no other reason than inflation moves nominal values higher (or lower when deflation occurs). But is there a predictable growth rate beyond the rate of inflation? What is predictable are the liabilities to pay pensions! Governments have promised to pay pensions and social security to individuals at their retirement age, sometime in the future. The ability to make these payments is based on some demographic population's contribution to pay today in order to support that Ponzi scheme - unless the value of those assets can be made to grow faster than seems possible.

The bottom line is that pension funds are failed forecasts of wealth. And the most extreme failure is Social Security – too many retirees supported by too few working members of society.

There is a limit to the available tax revenues any state or federal government can expect. When future liabilities exceed this potential revenue, they will fail….literally fail. The writer is correct in suggesting that we have created a potential disaster. That being said, this potential is not caused by academic or investor myths. It is caused, very simply, by the need for forward accounting – it is a cash flow problem. Governments (and their pension plan commitments) will not have sufficient cash flows to meet their forward commitments to pay.

Though the writer does not say it, she certainly suggests it, that unrealistic expectations of stock market growth have failed to balance accounts, and these future unfunded liabilities have grown to the point where there is no way to fund them – other than to restructure the expected payments downward.

This was an interesting article, Jack, and thought provoking. I think that your concern is well warranted. How will it impact our investment plans? That is an even better question, and one that I grapple with every day. How do we protect our capital first, and then grow it as well?