

The Muhlenkamp Memorandum

"What is Risk"-Part II (Continued)

If we also calculate the stock returns for these 3 periods, we find that in the '52 to '65 period, when bonds averaged a 2.1% return; stocks averaged 14.5%. In the '68 to '80 period, both stocks and bonds did poorly, but stocks did better than bonds by 6.7% to 2.6%. In the '81 to '92 period when bonds did very well, stocks did better 14.7% to 13.6%. To understand why this is so read our essay, "Why the Market Went Down."

At Muhlenkamp and Company, we believe the reason stocks perform better than bonds is not because they are "riskier" but because corporate management works for the stockholder and against the bondholder.

Chart 6 also shows that, after an unusually good decade, real long-term interest rates have returned to "normal" levels of roughly 3% over inflation. Rates are now 6-7%. To get returns greater than 6-7% will require a continued decline in interest rates, either because inflation continues down or because public enthusiasm for bonds causes an overshoot beyond fair value. While we believe each of these possibilities have a slightly greater than 50% probability, bond returns will no longer be driven by the unusually high real interest rates of the last decade. The time to be heavily invested in long bonds has just come to an end.

Chart 5 can also be read as the return investors expected from their purchases of bonds in each of the past 40 years. In fact these returns were guaranteed. Chart 2 shows the returns investors actually received. Realized returns were well below guaranteed returns until 1981.

Although we haven't yet constructed a chart for stocks similar to Chart 6, we judge the average stock to be priced to return 9-10%. The caveat is that stocks are normally more sensitive to public hopes and fears than are bonds, so corrections of 5-15% can occur at any time. Partly this is because stock prices are reported on the news every day and played up by the media and the brokerage community, while bond prices are largely ignored. Frankly, the most likely trigger for such a correction in stocks in the current environment would be an "uptick" in interest rates; and therefore a decline in the price of bonds.

When we put all of the above together, we see the following current conditions:

1. Inflation is 3-3.5%.
2. Short-term debt is likely to return a nominal 3%. (0% "real")
3. Long-term debt is likely to return a nominal 6-7% (3-4% "real"), with some volatility.
4. Stocks are likely to return a nominal 9-10% (6-7% "real"), with greater volatility.

Therefore, for money with a horizon beyond 3 years, we find the real returns available on stocks to be double those available on bonds, and we find both stocks and bonds to be more attractive than short term investments.

