

# BOOK REVIEW: *Stocks for the Long Run*<sup>1</sup>

Craig Marxsen<sup>2</sup>

Jeremy J. Siegel, the Russell E. Palmer Professor of Finance (since 1998) at the Wharton School of the University of Pennsylvania, provides an extensive revision in the fourth edition of his book that Amazon.com bills as “the most complete and irrefutable case for stock market investment ever written.” Released only a short time before the great stock market crash of 2008, this edition provides one of the timeliest perspectives for investors holding stocks, or considering holding them, in the aftermath of one of the most disheartening stockholder experiences suffered in the last 200 years. Siegel begins his book by examining the fate of a hypothetical investor. This hypothetical investor has followed John J. Raskob’s summer of 1929 advice to put \$15 per month into common stocks. Such an

investor would have done very well. By 1949 this investor would have accumulated \$9,000. This is an average annual return of 7.86% -- more than twice what a bondholder would have realized through the same Great Depression period.

The first chapter compares, over the period since 1802, returns on stocks with bonds, bills, and gold. With reinvestment of all interest, dividends, and capital gains, the total return on equities dominated all of the alternative assets. Indeed, even the Great Depression appeared as a mere minor blip in the relentless upward trend in stock portfolio values over the entire 200 years, while bonds and bills performed much less robustly, and gold showed no performance at all other than keeping up with inflation over the period. After World War II, when the U.S. (and most of the rest of the world) got off the gold standard, persistent inflation added a new dimension to risk. Total returns on either bonds or bills became subject to negative episodes in real, or inflation adjusted, terms, so that bonds and bills became riskier. Relentless inflation has made the real return on bonds and bills decline through time, and their holders have gained very little from holding them since 1926, Siegel reports. The “equity premium” has thus increased since the 1930s. Moreover, stocks earned substantially greater real return than earned on bonds and bills (and gold). This is seen in 16 different countries that Siegel charts for the period 1900 through 2006. Even if capitalism declines in the future, bonds and bills may fare far worse than equities in any political or economic upheaval our world of paper money may bring.

Chapter 2 examines the risk of stocks compared with bonds or bills. The risk is much higher for stocks if held for only

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<sup>1</sup> Siegel, Jeremy J. *Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies*. Fourth Edition. New York: McGraw-Hill, 2008. Pp. xxii, 380. (ISBN 0071494707; ISBN 9780071494700).

<sup>2</sup> Craig S. Marxsen, Ph. D., Associate Professor of Economics, University of Nebraska at Kearney, Kearney NE 68849. Email: marxsec@unk.edu.

one year – real losses have been as large as 38.6%. Whereas real losses on bonds have been no larger than 21.9%. However, that relative risk of stocks declines as the holding period lengthens. With a holding period to 17 years, over the past 200 years, never have people experienced any real loss with stocks. In contrast, bonds and bills have given negative real returns of 3% or worse: even when a 20 year holding period is examined. Additionally, for a sample period including the past 200 years, the standard deviation of real return for stocks falls below that of bonds and bills when the holding period increases between 15 and 20 years. Siegel compares the standard deviation predicted for stocks under the random walk hypothesis and finds that it is larger than the actual historical standard deviation. This suggests to Siegel that stock returns are mean reverting. That is, when the market falls below its trend, it later tends to recover back up to that trend; rather than, for example, continuing a random walk from a new and lower starting point. He shows that, to minimize the standard deviation of one's entire portfolio, it must contain a substantial fraction of stocks, and the longer the holding period, the larger that fraction must be.

Siegel is not oblivious to some of the doomsayers' concerns that the future might not be like the past 200 years. In Chapter 8, he examines the unprecedented demographic problem confronting the present cohort of prospective retirees in various places in the world. There is an imminent imbalance between old people attempting to liquidate financial assets and a relative dearth of young people alive to buy those assets. This supply and demand imbalance compounds the projected failure of social security systems challenged by the same root demographic problem. Siegel

contends that globalization of financial markets promises to resolve that demographic problem. Young people in developing countries will provide a market for the assets of old people in the advanced industrial economies that had too few babies to support their impending geezer gluts. Local, rather than global, markets confront an imminent imbalance.

Chapter 9 finds Siegel deviating from the "efficient market hypothesis" that holds that a security's market price is, at all times, "the best unbiased estimate of the underlying value of the enterprise." He prefers what he calls the "noisy market hypothesis". The noisy market hypothesis holds that stock prices are constantly being pushed away from their efficient market levels by buyers and sellers who are transacting for purposes unrelated to value. So called "liquidity" or "noise" traders are buying and selling for tax motives, for rebalancing portfolios, or for personal motives. Such noise drives some stock prices below their efficient market levels, and thus generating higher than normal returns for those assets. "Value stocks" sell below what their fundamentals would dictate. Accordingly, Siegel thinks purchasing value stocks can result in higher returns than would be expected from the market's broad average. Later, he suggests that this phenomenon points toward a strategy of investing in "fundamentally weighted" index portfolios based on something other than capitalization weighting. He likes earnings weighted indexing, for example, or dividend weighted indexing, where the total earnings of a company, or the total dividends paid out by a company, govern the proportion of a company's stock held in the index fund. Even if we cannot determine which specific stocks are value stocks selling for prices

lower than their true values, fundamental indexing in a noisy market is sure to pick up some such undervalued stocks. This is the opposite of buying so-called “growth stocks”. A focus on buying growth stocks tends to pick up overvalued stocks in a noisy market. Moreover, the fundamentally weighted indexing approach will automatically limit our buying into bubbles, since bubbles involve rising market values without rising earnings or dividends.

Siegel has filled his 21 chapters with practical advice for the ordinary investor. The book is complimentary to Burton Malkiel’s *A Random Walk down Wall Street*. Like Malkiel, who helped pioneer the first index fund at Vanguard, the large no-load mutual fund group renowned for low expenses, Siegel advocates index funds and passive investing for the bulk of an individual’s securities holdings. He devotes a number of pages to explaining why growth does not automatically bring a good return. Siegel explains why index investing based on the Standard and Poors 500 index leads to a predictable reduction in returns. The S&P 500 index’s popularity inflates the prices of any companies added into the index to replace dropouts. This popularity forces the many S&P 500 index funds to purchase immediately the stock of such added companies. He devotes one chapter to “Calendar Anomalies” and another to “Technical Analysis” that seeks to invest with the trend. “Behavioral Finance,” or the science that gives understanding of how human psychology systematically encourages human error in active investing strategies, provides a chapter strengthening the case for passive index investing strategies. Siegel thinks equities of firms based outside of the U.S. will likely grow to be over 82% of the future global equity market and he devotes a chapter to global

equity investing which he strongly advocates. He thinks an investor should put at least one third of an equity portfolio in international stocks. Another chapter is devoted to the impact political events have had on stock values. Siegel concludes that world events may upset markets in the short run but have proven unable to diminish the long-term returns as stocks revert to their mean returns.

*Stocks for the Long Run* came out before the crash of 2008. That is unfortunate. Since Siegel’s work pre-dates that event it fails to include Siegel’s explicit reaction to and encouragement for incorporating the crash of 2008 into an investment strategy. However, one cannot help but conclude that a post crash edition will embrace essentially the same advice that he gives in the book’s final pages: “If you are particularly anxious about the market, sit down and reread the first two chapters of this book.” While the crash may have cooled the average stockholder’s passion for stocks, it is unlikely that it dampened Professor Siegel’s enthusiasm. The aftermath of the crash has found Siegel writing, “stocks are still the best long-term investments”.<sup>3</sup>

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<sup>3</sup> MSN Money, <http://articles.moneycentral.msn.com/learn-how-to-invest/should-you-still-be-holding-stocks.aspx>, 7/15/2009.