y = 20.6 − 0.57X

Reading the Future?

An equation may reveal your stocks' five-year return

BY CAROL MARIE CROPPER

Inflated valuations have pushed down expectations for stock returns. They're now in the 5% to 9% range, say investment firms

In planning for the financial future, one key question is how much you can expect to earn on your investments. For stocks, the default answer has been 10.7% a year. That's the long-term average for large-cap stocks over the past 75 years, as reported by Ibbotson Associates.

The problem with that answer: It's an average over decades that tells you nothing about what might happen in the next 5 or 10 years—the time frame you might really care about. Two Seattle University finance professors have come out with what might be a better way to make that critical estimate. The equation involved is so simple even your sixth-grader could use it.

Professors Ruben Trevino and Fiona Robertson studied price-earnings ratios for the Standard & Poor's 500-stock index and its subsequent returns from 1949 to 2000. They found that high p-e's meant lower returns over the next five to 10 years. Also, you can estimate the five-year average annual stock return simply by multiplying the current p-e by 0.57, then subtracting the result from 20.67.

How does that work given today's market? Start with the p-e. The trailing p-e (the current price divided by the past 12 months' earnings) for the S&P 500 now stands at 46, more than three times its historic level, as calculated by Standard & Poor's. (You can get this information at www.spglobal.com/earnings.html.) Right now, that number is high because the past 12 months have been miserable for corporate earnings. Using the professors' equation, five-year annual returns would average a negative 5.6%.

But trailing p-e's always look high, especially when an economy is coming out of a recession. Suppose you substitute a p-e based on the next 12 months' earnings estimate. The "forward" p-e is 26, says S&P. That makes stocks look better, with an average annual return of 5.9%. But this is still far below long-term average returns.

Some big firms are telling investors to temper their expectations. A recent report from Merrill Lynch's quantitative strategy group says a 5% to 6% range is more reasonable than the 10% to 12% historic norm. T. Rowe Price Group predicts the high single digits, perhaps 7% to 9%, in the next 5 to 10 years, says spokesman Steve Norwitz.

Whichever projection you accept, it may mean working longer or saving more for retirement. Given returns of 7%, a $100,000 investment would grow to only $196,715 in 10 years, vs. $276,361 at 10.7%.

The professors caution that their findings are only "suggestive." They add there's no way to know how an equation based on history will apply when starting with today's unheard-of p-e levels. But Trevino thinks investors will get more accurate prognostications using his formula than by plugging in the historic average. Yale University economist Robert Shiller, author of the best-selling *Irrational Exuberance*, agrees—to a point. "Let's not think of it as God's revealed truth," he says of an equation designed to predict the future.

Even noted market bull Jeremy Siegel says the next 5 to 10 years will likely bring lower market returns. He predicts the S&P will yield 7.5% to 10% (or 5% to 7% after inflation). But for Siegel, a finance professor at the University of Pennsylvania's Wharton School, the problem is not so much an outsized p-e. Instead, he argues, stocks had been undervalued, so investors shouldn't expect as great a premium for holding them now.

For investors, that may be just another way of saying the same thing as the Seattle profs: Forget those plump double-digit returns in the coming decade. ■

How Your Equity Portfolio Could Grow

Two Seattle University professors studied the relationship between price-earnings ratios and returns from stocks. They came up with a simple formula to estimate how equity investments will grow: Multiply the p-e by 0.57 and subtract that from 20.67. Here are some predicted returns based on p-e ratios.

P-E RATIO*	PREDICTED RETURN**
5	17.82%
10	14.97
15	12.12
20	9.27
25	6.42
30	3.57
35	0.72
40	-2.13
45	-4.98
50	-7.83

*Based on last 12 months' earnings **Average annual return for next five years

Data: "P/E Ratios and Stock Market Returns," Ruben C. Trevino and Fiona Robertson, Seattle University; *BusinessWeek*