

Investing in stocks: How long is “long term” ?

How often have you heard or read that stocks held for “the long-term” are likely to outperform other investments?

It’s a generality, true, but there are statistics to back up that statement. For instance, according to Ibbotson Associates, large company stocks (as represented by the S&P 500) produced a total return from 1926 to 2004 of 10.4%, long-term government bonds (with maturities near 20 years), 5.4%.*

But those numbers need to be put in perspective. Very few, if any, of today’s investors were likely to have bought stocks way back in 1926 and have held them for 78 years. Which leads to the question, then, just how long is “long enough” for an investor who is concerned about risk to feel safe about investing in stocks?

This question is explored in a recent article written by Pu Shen, a senior economist at the Federal Reserve Bank of Kansas City. Based upon her analysis and computations, she concludes that stocks are “safer” than long-term government bonds for investors who have held their portfolios for more than 25 years. Over the years, for investors who have held their portfolios for shorter periods, both stocks and bonds were exposed to substantial risks, and stocks did not necessarily outperform government bonds.**

What’s more, the frequency of stocks returning less than inflation decreased as the holding period grew. According to Shen, when holding periods were 19 years or longer, the cumulative real return was never negative. Bonds, on the other hand, returned less than inflation as the holding period grew.

The conclusion that Shen reaches is one that all investors should consider. When making asset allocation decisions, you need to think carefully about how long is “long term” for your own portfolio and how much risk that you are willing to accept.

*The S&P 500 is an unmanaged index composed of 500 widely held securities considered to be representative of the U.S. stock market. Indexes are unmanaged. Investors cannot directly invest in any index. Past performance does not guarantee future results.

**Shen’s data are based upon the examination of cumulative real returns. Cumulative real returns are total return minus cumulative inflation (as measured by the Consumer Price Index for All Urban Consumers).

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Any developments occurring after January 15, 2007, are not reflected in this article.