

## The Power of Stocks

Over the past 100 years the total U.S. stock market has earned a 10.6% annualized rate of return (10.2% for the S&P 500 Index).<sup>1</sup> By comparison, over that period bonds delivered a 5.6% annualized return and gold 1.8%.<sup>1</sup> Mathematically, any investment with a 10.4% per year rate return doubles every seven years, quadruples every 14 years, and increases eight-fold every 21 years.

Stocks have the highest annualized rate of return of any major asset class measured over decades. While many portfolios include an important diversification role for bonds, commodities, and real estate, stocks are the powerplant of growth. Below we explore six common questions about stocks.

### What determines the value of a stock?

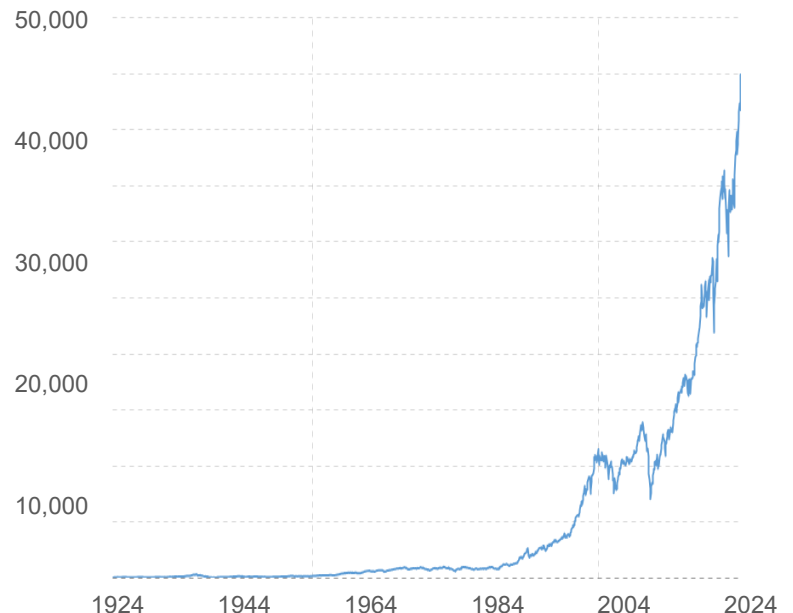
Stocks represent an ownership share of the assets and future profits of a company. They are often valued by analysts based on discounted cash flow models. That is, profits are estimated over several future years and then reduced by the expected risk-free return on a safe investment such as a treasury bond. Thousands of investment firms estimate these values daily and bid in a market like the New York Stock Exchange, where the buyers and sellers negotiate an equilibrium price. When economic or company-specific news emerges, studies show that stock prices may adjust in a few seconds or less.

### Can I lose money investing in stocks?

As the chart at right shows, stock indexes such as the Dow Jones Industrials consistently achieve new highs over time, rising exponentially for over 100 years. So, while an individual stock can fall to zero if the company goes out of business, a well-diversified stock portfolio should never lose money if held for a long enough period.

Bear markets represent the greatest commitment test for investors. These are painful declines of over 20% in a major stock index and usually coincide with frightening media predictions. Bears occur on average every 6.5 years and then recover over the next 1.5 years.<sup>3</sup> Many professional investors, including Warren Buffett, jump in and “buy low” when times feel darkest, and panicking retail investors look to sell.

**Dow Jones Industrials over Past 100 Years <sup>2</sup>**



**During the past 100 years, when measured over most 10 to 20-year periods, the average annualized gain for stocks is approximately 10% per year. What is special about this number?**

More specifically, stocks return near 7% plus inflation over long periods of time. Over the past 100 years, inflation has averaged 3%.<sup>1</sup> Over time stocks capture inflation because company assets increase in value with inflation, and most companies have the power to increase prices as their input goods increase. This 7% represents the rate of human ingenuity, development of new products, manufacturing efficiencies, etc. That 7% plus 3% inflation equals 10%.

**Can anyone predict how stocks will perform next year?**

Endless academic research, led by 1990 Nobel prize winner William Sharpe at Stanford, indicates no one has consistently predicted the market well.<sup>4</sup> This makes sense because according to the research of 2013 Nobel Prize winner Eugene Fama, the market moves each day based on unknowable events, and all known information is incorporated into current stock prices.<sup>5</sup>

Recent statistics indicate the experts are not getting any better. Bloomberg tracks 16 major investment firms including Goldman Sachs, Morgan Stanley, JPMorgan and Bank of America.<sup>6</sup> Over the past five years, the actual result of the annual S&P 500 Index performance was outside the range of all 16 firms' estimates. In 2022 all 16 substantially overestimated returns, and in the other four years, all 16 underestimated returns. In 2024, all missed by 10% or more.

**What is the best stock index to follow?**

The Dow Jones Industrials, Nasdaq Composite, and S&P 500 are constantly pushed in the media. These three indexes exist for historical reasons and are far from perfect, each with significant biases.

The Dow makes little sense as it represents only thirty stocks and is weighted by share price, which has little to do with company size. For example, Goldman Sachs and Verizon are similar in value, yet Goldman is weighted 14-times greater than Verizon in the Dow.<sup>7</sup> Walmart has a company value 8-times larger than Sherwin-Williams, yet Sherwin-Williams has a 4-times greater weighting in the Dow.<sup>7</sup>

The Nasdaq Composite was initiated in 1971 and gained popularity during the dot-com run-up. It makes more sense than the Dow in that it is weighted by market capitalization (company value) and includes over 2,500 U.S. and international stocks. However, it includes only stocks listed on the Nasdaq exchange and is heavily weighted toward tech stocks, so it is not a well-diversified representation of the total stock market.

The S&P 500 is more diversified. It consists of approximately 500 of the largest U.S. stocks and is also weighted by market capitalization. However, it excludes medium and small U.S. stocks and all international companies. This is significant because small stocks historically perform better than large stocks over long periods of time.<sup>5</sup>

Furthermore, the S&P 500 currently suffers from an oddity. The top six companies represent 30% of the S&P 500, and they are all tech-based.<sup>7</sup> The traditional diversified view across the 500 companies is lacking. While these big six have surged fantastically over the past two years, all mega-sized companies, especially in the tech sector, eventually lose their leadership. The graveyard of fallen tech-based leaders is endless and includes Compaq, Intel, AOL, Netscape, Zoom, Snapchat, Peloton and General Electric. Mega-caps are usually felled by competition or regulation. All six of the current mega-caps are currently in the cross hairs of regulators around the world, facing anti-trust litigation.

We recommend following the All-Country World Index (ACWI), which broadly represents all investible companies in the US. and other countries, weighted by market capitalization. It includes large, medium and small companies in both developed and emerging economies. This may not be the index reported often in the media but can easily be tracked by keying the ACWI ticker into any stock-tracking app.

### **What are the tax advantages of investing in stocks?**

Stocks have a tax advantage over bonds and real estate. While income from bonds and real estate is taxed as regular income in the year received, stock gains (and most dividends) may be taxed at the long-term cap gains rate, which is generally lower than income tax rates. Also, since cap gains are only taxed in the year stocks are sold and not as gains accrue, paying cap-gains taxes is controllable. Finally, stocks receive a cost basis step up when the estate passes, whereby all cap gains (and associated taxes) are eliminated.

While most mutual funds have annual taxable capital gains distributions within the funds, we primarily use exchange traded funds (ETFs) which usually have zero taxable capital gains distributions.

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Over time stocks have proven their wealth building potential for investors who remain disciplined and diversified. A hundred years of data demonstrates their long-term potential. Although risks are associated with investing, sticking to a plan and riding out the inevitable declines will reward investors. For any additional questions, contact your advisor.

### **Notes and Acknowledgements:**

1. Stocks for the Long Run, Sixth Edition, Professor Jeremy J. Siegel, Wharton School of Business at Penn University, 1926-2021
2. Macrotrends, 1925-2024
3. "Guide to Markets," JPMorgan, 2024
4. William Sharpe, Stanford graduate School of Business, 1990 Nobel Prize in Economics
5. "The Cross-Section of Expected Stock Returns," Eugene Fama and Kenneth French 1992
6. "Wall Street's Dubious Forecasts," Bloomberg, December 27, 2024
7. Slickcharts, Companiesmarketcap.com as of December 31, 2024