KEATING
WEALTH MANAGEMENT

Capital Markets Distilled

Average Annual Nominal Rates of Return: 1926-2016				
10% Large-cap stocks	**12%** Small-cap stocks	**6%** Investment-grade corporate bonds	**3%** Inflation	**40 months** Average duration of bear market to reach previous market peak

Investors who confuse volatility with risk are likely to harm themselves—seriously and permanently.

Average Annual Rates of Return

According to investment research firm Morningstar, from 1926 through 2016, large-cap U.S. stocks delivered an average annual compound nominal return of 10%, small-cap stocks 12%, and long-term U.S. investment-grade corporate bonds 6%. These all look pretty good until inflation is factored in, which averaged 3% during this same period. Deducting inflation from the returns dramatizes the superior returns of equities (7 to 9% real returns), which were two to three times greater than those from bonds (3% real return).

Why Stocks Return More than Bonds: Volatility

The reason why stocks offer superior long-term returns is because it is impossible to forecast what they will do in the short run. Equities are more volatile than bonds, which explains their higher returns. The bumpy ride is the reason for the return.

Volatility Does Not Equal Risk

However, we don't equate equity volatility with risk. Volatility is just a short-term disturbance (often times gut-wrenching), but the long-term returns from equities are enduring. You should own equities because they go down temporarily and up permanently.

Risk: Permanent Loss of Capital

The real risk for an investor is the danger of unwittingly turning a temporary decline into a permanent loss of capital by panic selling. When we look at the stock market, we see volatility rather than permanent loss, and we don't mistake one for the other. On a cyclical basis, stock prices do fall—temporarily. And then they recover. Mistaking volatility for loss can be very destructive.

Riding Out Volatility

Over the past 30 years, the average intra-year decline in the stock market has been a bit under 15%, and smaller drops of 5% have happened about four times a year. Bear markets (a downturn of 20%) occur about once every five years, with an average drop of over 30% and an average duration of 16 months. And it has taken the stock market just 40 months to pass from a market high through the trough of a subsequent bear market and then return to where it started.

In order to be an equity investor, you have to be willing to ride out a 15% decline nearly every year and then a bear market with an average 30% decline about once every five years. Our most important value is helping you stay the course through these periods of predictable volatility to enjoy the long-term rewards.