

*Fundamentals suggest to us that stock returns are likely to be good over the next decade.*

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## The Case for the 20,000 Dow

Individual and institutional investors alike have been shifting their capital from stocks to cash and bonds at a rapid rate in recent years, despite extraordinarily low interest rates. We think that 10 years from now, investors will wish they had stayed in stocks—or added to them.

It's tempting to give up on stocks after more than a decade of high volatility and low returns from stocks—and lower volatility with higher returns from bonds. Because we are human, we tend to expect the future to resemble the recent past—to become “anchored” in our

recent experience. Even some experts argue that the world has entered a “New Normal” condition in which stocks have permanently lost their return edge.

We've heard this before. It was wrong then, and we think it's wrong now, too.

In 1979, for example, *BusinessWeek* published a cover story famously called “The Death of Equities.” Then, like now, stock market returns had lagged 10-year Treasury returns for a decade.

Stock returns had been dragged down by the bursting of a bubble (the Nifty Fifty) and bleak economic conditions. OPEC had unleashed its second oil-price shock in five years. The so-called misery index—the sum of the unemployment and inflation rates—was 20% in the US, double its level today. And corporate profits were very weak.

*BusinessWeek* was capturing widespread sentiment about the economic and market outlook. Nonetheless, stocks handily beat bonds over the 10 years starting in 1979.

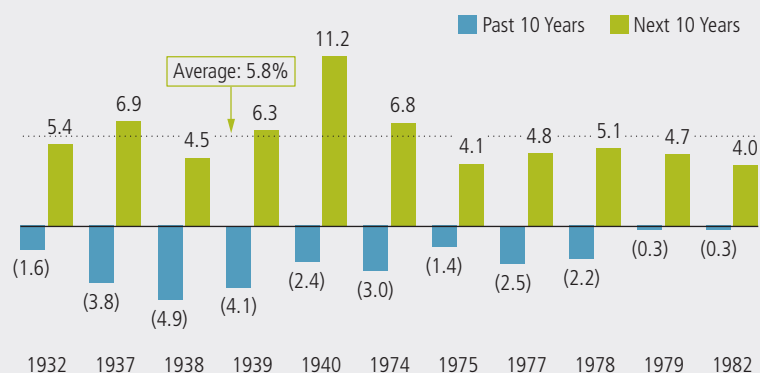
As the ubiquitous legal disclosure says, past performance does not guarantee future returns. Indeed, performance often reverses sharply.

Between 1901 and the onset of the recent credit crisis, there have been 11 10-year rolling periods in which bonds beat stocks, all of them coinciding with the Great Depression or the stagflation of the 1970s. And after each and every one of them, stocks beat bonds for 10 years—on average, by 5.8% (*Display 1*).

It takes guts to buck the trend. But at a September 1983 client conference, we cited good fundamental reasons in making “The Case for the 2,000 Dow.” The Dow Jones Industrial Average was

Display 1: Stocks Roared Back After Each Decade that They Lagged

S&P 500 Return Minus 10-Year Treasury Return: Percent



Historical performance is no guarantee of future results.

Includes all 10-year rolling periods when the S&P 500 lagged 10-year Treasury bonds from 1901 through the beginning of the 2008 credit crunch; the average is for the green bars

Source: Global Financial Data, Standard & Poor's, and AllianceBernstein

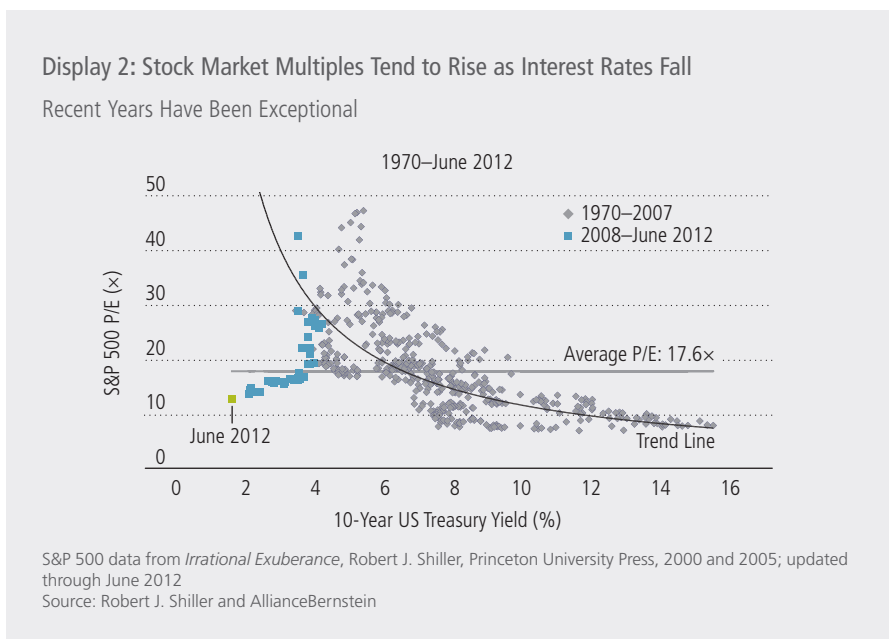
then slightly below 1,300. It reached 2,000 in January 1987, about three and a half years later.

Today, our median annual return projections for global and US stocks are about 8% over the next 10 years, far ahead of our projected 2% median return for 10-year Treasuries. At that rate, the Dow could hit 20,000 in five to 10 years. In the same time frame, the S&P 500, a more representative index, could hit 2,000. (It's now around 1,300.)

Our projected stock returns may sound optimistic. They're not. They are well below the long-term average for US and global equities and based on conservative assumptions about economic and market conditions. Bonds, on the other hand, are unlikely to outpace inflation, because current yields are extremely low.

Clearly, there is enormous uncertainty about the outlook for the economy and the capital markets over the next decade. As a result, basing an investment strategy on a specific forecast would be unwise. A better approach, in our view, is to base one's strategy on the likely range of outcomes. There are two good techniques for doing so. The first is to make a set of scenario forecasts based on key fundamental drivers and estimate how they would affect returns. The second is to build a capital markets model that can predict the distribution of returns and the likelihood of extreme events.

We've done both. In this paper, we explore the fundamental reasons why we think stocks are likely to deliver good returns over the next decade. We also offer our Capital Markets Engine's projections of the range of outcomes for stocks and bonds, to explain why long-term investors need stocks to avoid shortfall risk.



### Are Stocks Expensive?

We recognize that the US and global economies continue to be scarred by the credit crunch that began in 2008. Significant risks remain, particularly in Europe. Economic recoveries after financial crises almost always take longer than recoveries after ordinary downturns.

The global economy may take several more years to fully recover from the credit crunch—and so may the stock market. Both could weaken again before getting better. Our research<sup>1</sup> has found that after 15 prior systemic banking crises around the world, the stock market took nine years, on average, to regain its prior peak. We don't know if the recovery from the recent crisis will take a longer or shorter time than average, but assuming it is average, we're now about halfway through.

But even taking these risks into account, we don't agree with those who argue that the stock market is overvalued. To begin with, it doesn't make sense to say the market is expensive, given where

bond yields are today. *Display 2* shows the remarkably close relationship between the S&P 500's price-to-earnings (P/E) multiple and the 10-year Treasury yield since 1970. (The curved trend line shows the average P/E for a given level of interest rates.) In general, stock market valuations have been high when interest rates were low, and low when interest rates were high—for good fundamental reasons.

Low bond yields tend to reduce companies' borrowing costs. They also drive up the present value of future earnings and dividends, and they make bonds a less appealing alternative to stocks. High bond yields, by contrast, drive up companies' borrowing costs, reduce the present value of their future earnings and dividends, and make bonds more appealing relative to stocks.

Since the beginning of 2008, 10-year Treasury yields have been below 4%, and the market P/E has been far below the trend line almost all the time, as shown by the blue squares in *Display 2*. The few

<sup>1</sup>"Is This Time Different? Systemic Financial Crises and Their Effect on Economies and the Markets," Jon Ruff and Vincent L. Childers, AllianceBernstein, January 2009

### Display 3: What the S&P 500 at 1,300 Implies

Long-Term Expected Returns Under Five Scenarios

Scenario	EPS	Dividend Yield	Earnings Growth*	Final P/E	Annualized Return	Years to Dow 20,000†
Current Earnings, No Growth	\$104	8%	0%	12.5×	8%	Infinite
Current Earnings, Normal Growth	\$104	2%	6%	15.0×	9%	5
Current Earnings, P/E Normalized Relative to Interest Rates	\$104	2%	6%	20.0×	—	0
Normalized Margins, Normal Growth	\$74	2%	6%	17.5×	5%	10
Normalized Margins, Low Growth	\$74	2%	2%	17.5×	4%	20

As of June 30, 2012

\*Assumes constant payout ratio, so that dividends grow with earnings

†Assumes Dow Jones Industrial Average continues to be roughly 10 times S&P 500

Source: Thomson I/B/E/S and AllianceBernstein

blue squares above the trend line are for very late 2008 and 2009, when earnings fell to very low levels.

In June 2012, the 10-year Treasury yield was below 1.5% and the S&P 500's P/E was 12.5, far below and to the left of the trend line. It's the green dot in Display 2, the extreme outlier. To fit on the trend line, the S&P 500's P/E would today have to quadruple, to about 50! While we certainly don't think the market should be trading at 50 times earnings, today's low bond yields suggest that the market should be trading at or above 17.6 times earnings, its average multiple since 1970.

Furthermore, many people cite the Shiller cyclically adjusted P/E ratio as evidence that the stock market is too expensive. This backward-looking metric compares stock prices with inflation-adjusted 10-year trailing earnings. However, the last 10 years were not typical: Earnings were depressed by the recession in late 2008 and 2009.

Our approach is forward-looking. It starts with the premise that the stock market is not a casino and stock prices are not pulled out of thin air: They reflect the intrinsic value of companies' future earnings.

#### Stock Fundamentals

Stocks represent an ownership claim on a share of company earnings. Hence, stock prices reflect (imperfectly, of course) the value of companies' current earnings and potential earnings growth. In computing the expected returns for stocks, what matters is the starting price, earnings, dividends (the portion of earnings distributed to shareholders), earnings growth, and changes in P/E. As you might expect, low starting prices, high earnings and dividends, high growth, and P/E expansion are all good for future stock returns.

The models we use when investing are complex, but a simple argument makes the point. The expected return for a Treasury bond held to maturity is equal to its yield. Similarly, the expected return

for a stock equals its earnings per share (EPS) divided by its price—its earnings yield—if the company has no growth prospects and therefore returns all of its earnings to shareholders. If the company has growth prospects, it would retain some of its earnings to fund growth. In that case, the expected return equals the dividend yield plus dividend growth. If the company pays out a constant share of earnings as dividends, dividend growth equals earnings growth.

Let's apply this framework to the S&P 500's price level of about 1,300 in early June 2012. Consensus forecasts call for the index to have \$104 in earnings per share this year. If the companies in the index didn't expect any growth, they would pay out all their earnings as dividends, and earnings and dividends wouldn't grow. The S&P 500's dividend yield would be 8% (*Display 3, first row*).

If the P/E remained unchanged, the total return would also be 8%, but both the S&P 500 and the Dow would stay at their current level. While a flat index price might be disappointing, we think most investors today would probably welcome an 8% return on investment.

#### What About Growth?

Of course, the companies in the S&P 500 do retain a portion of their earnings to finance growth, so the index's dividend yield is slightly above 2%, rather than 8% (*Display 3, second row*). What kind of earnings growth should we assume?

Historically, earnings and the stock market have grown with the economy over time, although they can diverge for several years at a stretch, particularly if market euphoria drives stock prices to very high multiples of earnings, or gloom drives stock prices to low multiples. Nominal US GDP<sup>2</sup> (which includes inflation) has grown 7% a year on

<sup>2</sup>GDP growth is more commonly quoted in real, or inflation-adjusted, terms. We use nominal growth here to match data for earnings growth and the stock market.

average since 1947—and so have the S&P 500's earnings and price (*Display 4*).

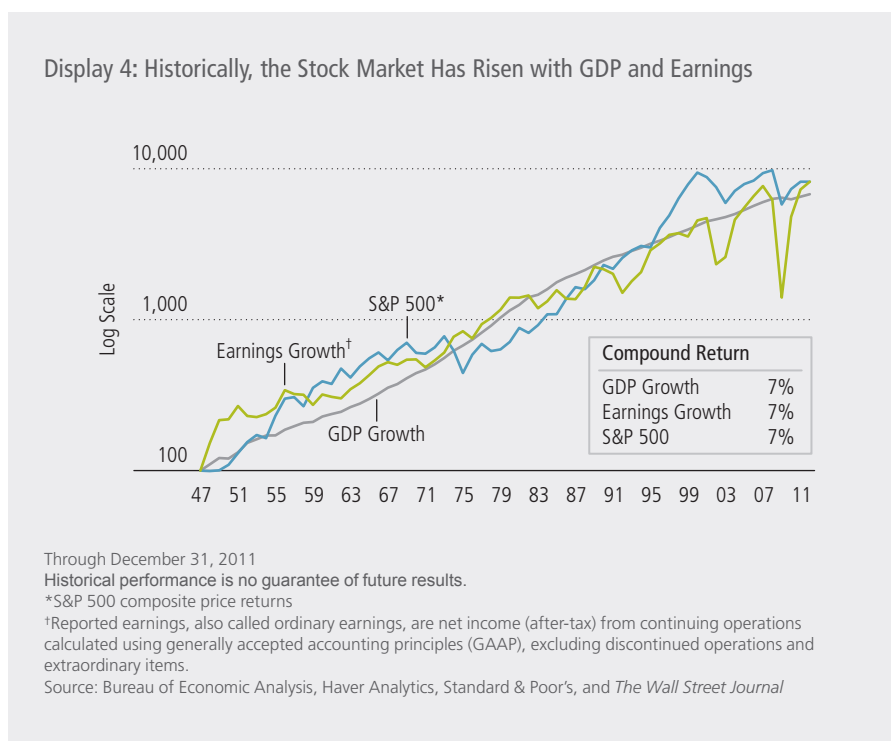
The three key variables that drive both economic growth and earnings growth over the long term are inflation (which increases the nominal value of economic output), population growth (which boosts the number of people consuming and producing goods), and productivity (which increases the output per person or per unit of capital).

Inflation is widely expected to average about 3% over the long term; population growth, to average about 1%; and productivity, to continue to rise about 2%. Since  $3\% + 1\% + 2\% = 6\%$ , 6% is a plausible long-term economic growth forecast, although it's somewhat below the postwar average and the International Monetary Fund's projections for the next five years.<sup>3</sup>

So let's assume 6% economic and earnings growth. With a constant dividend payout ratio, this would lead to 6% dividend growth. Eventually, this growth rate would probably make investors less gloomy, and the market would rise from its current low level of 12.5 times earnings.

If the S&P 500's P/E rose to 15—halfway back to its average of 17.6 since 1970—the market's expected return would be 9% per year. At that rate, the S&P 500 would reach 2,000 in five years. The Dow, which typically trades at about 10 times the S&P 500, would reach 20,000 in about five years, too (*Display 3, second row*).

But as discussed above, the market should arguably be trading at an above-average multiple, since bond yields are so low. If the S&P 500's P/E rises to 20 times earnings as sustained growth in a low-interest-rate environment makes



investors more confident, the Dow could reprice to 20,000 immediately (*Display 3, third row*).

Since most investors today would probably welcome an 8% or 9% return for the next five to 10 years (let alone an immediate market revaluation), the current limited appetite for stocks suggests that investors don't believe in these scenarios. Most likely, they don't believe in the consensus forecast of \$104 in earnings per share this year or 6% economic growth. So let's examine the implications for stock returns of lower earnings and slower economic growth.

### What If Earnings Fall or GDP Growth Slows?

Many people expect earnings to decline because margins are far higher than usual. If corporate spending picks up from the unusually low levels of recent years, margins would fall, and that could drive down earnings.

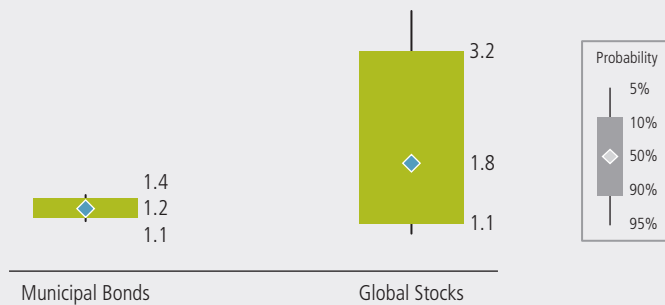
We think it's reasonable to expect margins to decline somewhat—although not necessarily to their historical average. But for the sake of argument, let's look at what would happen if margins declined from 9.5% today to their long-term average of about 6.75%.

Even in this scenario, the S&P 500 would reach 2,000 and the Dow would reach 20,000 in 10 years. Applied to current revenues, 6.75% margins would reduce S&P 500 earnings by about 30%—to \$74 (*Display 3, fourth row*). While there would likely be a severe market pullback initially, if normal economic growth resumed and P/E ratios normalized, the S&P 500 would have a 5% total return and reach 2,000 in 10 years.

But the global economy is now weak, and the European sovereign debt crisis could end up being a drag on economic growth for years. What if Europe and the US enter a lengthy period of disinflation?

<sup>3</sup>"World Economic Outlook: Growth Resuming, Dangers Remain," International Monetary Fund, April 2012

Display 5: The Projected Range of Outcomes for Bonds Is Both Narrow and Low  
Range of Portfolio Values After 10 Years on \$1 Million Initial Investment (\$ Millions)



Based on Bernstein's estimates of the range of nominal returns for the applicable capital markets over the next 10 years for a taxable account, assuming 6.5% state tax. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains or losses would be realized that are not reflected here. Bonds modeled as intermediate-duration diversified municipals. Equities modeled as 21% US diversified, 21% US value, 21% US growth, 7% US SMID, 22.5% developed international, and 7.5% emerging markets. See Notes on Wealth Forecasting System on page 7 for further details.  
Source: AllianceBernstein

That's possible, particularly if policy makers are unsuccessful at addressing the world's serious macroeconomic problems.

So let's perform a stress test and assume inflation of only 1%, population growth of 1%, and no productivity growth at all. That would give us nominal GDP growth of just 2%. A recent survey of professional forecasters said there's less than a 10% chance that economic growth will be that slow over the next three years.<sup>4</sup>

What would these dismal economic forecasts imply about future earnings growth and stock returns? If we assume the S&P 500 earns \$74 per share this year, 2% growth would still get us to a 4% annualized market return if the market P/E ultimately returns to average (*Display 3, fifth row*). At that rate, it would take 20 years for the S&P 500 to reach 2,000 and the Dow to reach

20,000. Such returns are hardly enticing, but they are still likely to exceed bonds.

Of course, stock-market returns could be worse than 8% (or 4%), particularly in the short term. S&P 500 earnings could fall below \$74, and anxiety could cause market valuations to drop even further below normal; both happened in early 2009. Other market shocks are also possible. For example, very high inflation with slow growth could cause price-to-earnings multiples to contract.

But market returns could also be better. Our stress test incorporated draconian assumptions—a 30% drop in earnings plus no productivity growth at all, a very rare occurrence over a 10-year period. Human ingenuity has led to remarkably persistent and steady productivity growth in the postwar period. In recent years, new technology and globalization have

driven productivity growth. In the future, these trends and others not yet imagined are likely to continue to drive it.

Faced with uncertainty and traumatized by losses in recent years, investors who are avoiding stocks appear to be assuming that the worst outcomes are highly likely to occur. Or, perhaps, they've just lost their stomach for market volatility and are prizing near-term stability over potential long-term gains.

### What About Bonds?

Investors fleeing stocks have mostly sought shelter in bonds.<sup>5</sup> High-quality bonds are almost always more stable than stocks, and they typically provide reliable income. And over, say, a 10-year time frame, their returns are also much easier to project.

Expected returns for 10-year Treasury bonds are typically close to the starting yield, so the range of possible outcomes is narrow. Today, yields are extraordinarily low. In early June, the yield on the 10-year Treasury fell to 1.47%—the lowest level since the beginning of the Treasury market in 1790. Yields on five-year AAA municipal bonds (which taxable investors are more likely to invest in than Treasuries) are about 0.75%, close to their lowest point in the data history available since 1950.

Our Capital Markets Engine uses a far more nuanced model than the one we used earlier in this paper. It projects 10,000 plausible outcomes (not five) for the markets based on initial conditions and proprietary econometric models.<sup>6</sup> Given today's very low bond yields, our Capital Markets Engine projects that \$1 million invested in intermediate-duration municipal bonds today would be worth between \$1.1 million and \$1.4 million

<sup>4</sup>"Survey of Professional Forecasters," Federal Reserve Bank of Philadelphia, May 11, 2012

<sup>5</sup>For simplicity's sake, we've focused this paper on stocks versus bonds. But we also think alternative investments, including hedge funds, should play a role in many investors' portfolios. See An Alternative View, Bernstein Global Wealth Management, November 2010.

<sup>6</sup>Dokyoung Lee and Seth J. Masters, "Long-Horizon Investment Planning in Globally Integrated Capital Markets," The Journal of Wealth Management, Spring 2012

after 10 years, excluding the best and worst 1,000 scenarios, with a median return of \$1.2 million (*Display 5, previous page*). That's not likely to keep up with inflation, let alone support 3% spending per year.

Our projected range of outcomes for stocks is, as always, much wider. Our Capital Markets Engine projects that \$1 million invested in global stocks today would be worth between \$1.1 million and \$3.2 million after 10 years (excluding the best and worst 1,000 scenarios).

But the lower end of our projected outcomes for stocks is about the same as the lower end of our projected outcomes for municipal bonds, even though stocks have much greater upside and a higher median projected value of \$1.8 million. The latter reflects a current projected annualized median return of about 8%. That's somewhat below our normal level, principally because we expect profit margins to come down somewhat from current high levels.

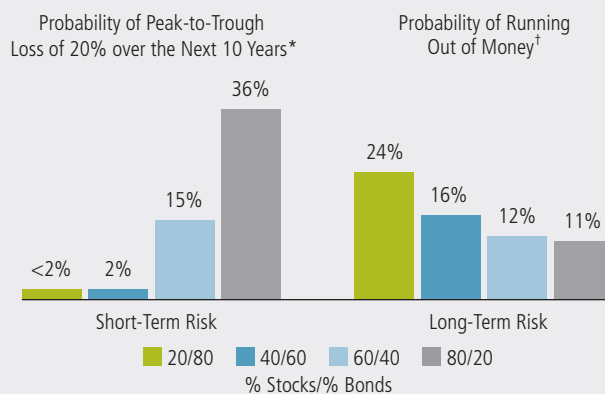
As a result, we now project that the odds of global and US stocks beating bonds over the next 10 years are 88% today; usually, stocks have a 75% chance of beating bonds over 10 years.

### What This Means for You

All this has important implications from the point of view of your long-term investment goals.

Despite low yields, bonds should still play their usual roles in your portfolio: providing income, preserving capital, and providing protection in times of stock-market distress (because bond prices tend to rise at such times). In the event that we do end up experiencing one of the worst of our projected scenarios, bonds will be especially important.

Display 6: Risk by Asset Allocation—Two Perspectives



Data do not represent past performance and are not a promise of actual future results or a range of future results.

\*Projections indicate the probability of a peak-to-trough decline in pretax, pre-cash-flow cumulative returns of 20% over the next 10 years. Because the Wealth Forecasting System uses annual capital market returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above include an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years.

†Represents the probability of running out of money for a 65-year-old retired couple spending 3% from the portfolio per year, on an inflation-adjusted basis. In our analysis the life span of an individual varies in each of our 10,000 trials in accordance with mortality tables compiled in 2000. To reflect that high-net-worth individuals live longer than average, we subtract three years from each individual's age (e.g., a 60-year-old would be modeled as a 57-year-old). Based on Bernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. See Notes on Wealth Forecasting System on page 7 for further details.

Source: AllianceBernstein

Most investors are likely to need stocks to feel confident that they will have enough to live on. Remember, volatility isn't the only type of risk. There's also shortfall risk—not having enough money to meet your spending requirements. Investors must weigh both types of risk when making strategic asset allocation decisions.

If you're thinking about market volatility, bond-oriented portfolios may look very appealing, especially given today's highly uncertain macroeconomic outlook. We estimate there is less than a 2% chance that a portfolio with a 20% allocation to stocks and 80% allocation to bonds will suffer a 20% peak-to-trough loss over the next 10 years, compared with the 15% chance of such a loss for a portfolio with 60% in stocks (*Display 6, left side*).

But if you're thinking about shortfall risk, a portfolio with 60% in stocks looks

more attractive (*Display 6, right side*). We estimate that a 65-year-old retired couple willing to withdraw only 3% of their portfolio, grown with inflation, has a 12% chance of running out of money if they invest in the portfolio with 60% in stocks. That may not sound great, but it is materially better than the 24% odds of running out of money if they invest in a portfolio with 20% in stocks.

In sum, highly uncertain macroeconomic conditions make large stock-market drops more likely than usual—and very low bond yields provide a thinner cushion. As a result, market risk can't easily be avoided. And trying to avoid market risk is not a good strategy if it increases shortfall risk too much. A 20% loss is certainly painful, but it doesn't hurt as much as running out of all of your money. ■

## Notes on Wealth Forecasting System

The Bernstein Wealth Forecasting System<sup>SM</sup> (WFS) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFS consists of a four-step process: (1) Client Profile Input: the client's current assets, income, expenses, cash withdrawals, tax rate, risk tolerance, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indexes, not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases.

Asset-class projections used in this paper reflect initial market conditions as of March 31, 2012. They include the following median forecasts of 40-year compound rates of return: US diversified stocks (represented by the S&P 500 Index), 8.7%; US value stocks (represented by the S&P/Barra Value Index), 9.0%; US growth stocks (represented by the S&P/Barra Growth Index), 8.5%; US SMID stocks (represented by the Russell 2500 Index), 8.8%; developed international stocks (represented by the Morgan Stanley Capital International [MSCI] EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged), 9.3%; emerging markets stocks (represented by the MSCI Emerging Markets Index), 7.6%; municipal bonds (represented by AA-rated diversified municipal bonds with seven-year maturities), 4.5%; and inflation (represented by the Consumer Price Index), 3.4%. Expected total returns on bonds are derived taking into account yield and other criteria. Globally diversified equity portfolios comprise an annually rebalanced mix of 21% US diversified stocks, 21% US value stocks, 21% US growth stocks, 7% US SMID stocks, 22.5% developed international stocks, and 7.5% emerging markets stocks.

An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized. ■

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