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If history is your guide, stocks are best bet for retirement strategy

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With the carnage in the equity markets around the world over the past few months, and negative news hitting the media daily, it's tempting to ask "are equities dead?" A historical perspective will put this question in context and help the millions of baby boomers approaching retirement figure out what to do with their investments to secure a comfortable future.

I looked at the performance of four asset classes from 1957-2003: small-cap stocks, large-cap stocks, government of Canada bonds and treasury bills. I surveyed the entire universe of more than 1,200 Canadian stocks, using the Canadian Financial Markets Research Center's database at the University of Western Ontario. The average annual return of small-cap stocks was about 16 per cent, large-cap stocks 10 per cent, government of Canada bonds 7 per cent and T-bills 6 per cent.

While these were average 1957-2003 returns, the actual annual returns of these asset classes varied by different amounts around these averages, depending on their risk. For example, 70 per cent of the time, small-cap stocks' returns, the riskiest asset class examined, varied between a loss of 4 per cent and a gain of 36 per cent; those of T-bills, on the other hand, the lowest risk asset class, varied between 5 per cent and 7 per cent. However, it would take, on average, 20 years to double your money if you invested continuously in T-bills and only five years if you invested continuously in small-cap stocks.

Is history a good guide of the future? Typically, it has been. The 47-year period covered by my research was a period of severe recessions, mild recessions, high inflation, low inflation, high interest rates, low interest rates, a market crash in 1987 and a bubble burst in 2000.

Will such market behaviour repeat? Chances are it will. It's tempting to say that this time things will be different. But as the late Sir John Templeton said "the most expensive words to say are that this time things will be different."

However, future returns may end up being lower than historic ones. Financial market deregulation, financial market innovations and ample availability of cheap credit over the past 20-to-25 years, increased people's willingness to borrow. This fuelled economic activity and financial markets.

Future performance may be curtailed by possible regulatory changes at financial institutions, which may hinder similar leveraging.

Restricting credit will lead to lower gross domestic product, lower corporate profits and stock price appreciation compared with historical experience. But despite the prospect of possibly lower returns, the relative relationship between the various asset class returns will be maintained. In the long run, investing in equities is the better move.

Equities produce dividends, growth and growing dividends, as opposed to fixed income securities whose income remains constant. Government bonds have historically and in the long run underperformed equities; currently their yields are at a historical low point. Moreover, inflation may be an issue in the future that will hurt bonds.

Recent injections of massive amounts of liquidity into the global system may provide short-term gain for long-term pain. When confidence returns in the financial markets, watch out! Inflation is bound to increase – stocks are a good hedge against inflation; bonds are not.

So what about baby boomers approaching retirement? They need to invest in securities with low volatility. This will prevent a repeat of this year's scenario, with people postponing retirement as a result of the collapse of the financial markets. This does not mean staying out of equities altogether.

My advice is for soon-to-be-retirees to avoid commodity and high-tech stocks. They should invest in high-quality stocks that pay large dividends, specifically companies that have increased their dividends in good and bad times, including utilities, wealth management firms, consumer staples, health-care stocks and good quality consumer companies that make things we all need and use.

On the fixed-income side, inflation protected (or real return) bonds offer the best option.

Instead of investing in high MER mutual funds, look at exchange-traded funds (ETFs) that offer good diversification at low cost – while avoiding sectoral ETFs and country-specific ETFs. Investors need to remain diversified using ETFs that cover a wide cross-section of the markets, domestically and globally.

In terms of individual stocks, value stocks in the long run beat growth stocks. Investors should avoid high P/E and price/book stocks, instead focusing on low P/E and low price/book companies, as well as companies that produce things we need regularly, especially those with a significant competitive advantage that will prevent competitors from entering the market.

Retirement is a point in the human life cycle. It is not the end. People live well into their retirements and need to ensure that in 20-30 years they don't outlive their money. The best way to do this is by investing in high-quality equities.

Those in early retirement can allocate a larger percentage in equities than fixed income. Later on, the weighting of fixed income needs to increase as the need for steady and frequent income outweighs the need for growth.

For investors still in the market, it is too late to do anything. There is more upside at this point than downside. Historically, individual investors have tended to buy high and sell low; so at this point investors should hold on. At the end of the day, however, investors should educate themselves and realize that there is no free lunch – higher returns in the long run normally go with higher risk.

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By the numbers

16 Average annual percentage gain of small-cap Canadian stocks from 1957-2003.

10 Average annual percentage return of large-cap stocks over the period.

7 Average annual percentage gain of Canada bonds over the period.

6 Average annual percentage return of T-bills over the 47-year period.

20 Number of years it would take to double your money if you invested continuously in T-bills from 1957-2003.

5 Number of years it would take to double your money if you invested continuously in small-cap stocks.