Reviewing *The Future for Investors*

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In this article, Bruce Grantier, Vice President, Pension Assets at Scotiabank and Brandes Institute Advisory Board member, shares his perspective on Jeremy Siegel's latest book, The Future for Investors: Why the Tried and True Triumph Over the Bold and the New. *The Journal of Investment Management (JOIM) published a condensed version of this review in its Fourth Quarter 2005 issue. This piece is published as a Brandes Institute article with permission from the JOIM.*

Jeremy J. Siegel's very successful book *Stocks for the Long Run*[2] made the case for stocks over bonds. His new book addresses the important question: which stocks? *The Future for Investors* reflects an evolution in Siegel's thought away from indexing as the preferred strategy for equity investing toward embracing the benefits of active management. In the Preface, he writes, "Irrational fluctuations in the market, instead of being a source of alarm, give investors the opportunity to do even better than the buy-and-hold returns available on indexed securities" (xiv). This review briefly summarizes the book, comments on Siegel and Schwartz' original paper on performance of the unmanaged S&P 500 Index[3], and relates the book to value investing and behavioural finance by reference to two recent surveys of academic literature that I conducted.

The book contains a few main themes: 1. the exceptional performance from 1957-2003 of the so-called "tried and true" – the value stocks of the S&P 500 2. the implications for investment returns of potential dis-saving by aging baby-boomers, and 3. the advantages of global investing.

The overall theme of the book is that valuation is more important than earnings growth in determining investment returns. The empirical basis for this is a detailed study of each S&P 500 company since the modern inception of the Index on March 1, 1957, through year-end 2003.

To measure the performance of the original S&P 500 firms, Siegel initially created three, cap-weighted portfolios. Over time, he divided this 500-stock portfolio into three, separate portfolios based upon the following approaches:

1. Survivors: When original S&P 500 companies merged or were taken private, the shares were sold and the proceeds invested in the surviving constituents. By year-end 2003, this portfolio consisted of 125 stocks, including Philip Morris, Pfizer, and Coca-Cola.

[1] Siegel, Jeremy J. *The Future for Investors : Why the Tried and the True Triumph Over the Bold and the New*. New York: Crown Business. 2005.

[2] Siegel, Jeremy J. *Stocks for the Long Run*. New York: McGraw Hill. 1994.

[3] Siegel, Jeremy J and Jeremy D. Schwartz. "The Long-Term Returns of the Original S&P 500." December 2004. The Wharton School. To be published in the *Financial Analysts Journal*; draft available on Jeremy Siegel's website, www.jeremysiegel.com.

2. Direct Descendents: This includes all firms that merged. Spin-offs were sold and reinvested into the parent firm. It contained 228 firms at the end of the study.

3. Total Descendents: This portfolio includes all corporate spin-offs (as well as mergers). Siegel describes it as "the ultimate buy-and-hold portfolio" (24). It contained 341 firms at year-end 2003.

According to the results, "returns on the original firms in the S&P 500 beat the returns on the standard, continually updated S&P 500 Index and did so with lower risk" (24). Table 1 summarizes Siegel's findings:

TABLE 1

Portfolio	Accumulation Based on $1,000 Investment	Annual Return	Standard Deviation
Survivors	$151,261	11.31%	15.72%
Direct Descendents	$153,799	11.35%	15.93%
Total Descendents	$157,029	11.40%	16.08%
S&P 500 Index	$124,522	10.85%	17.02%

Source: *The Future for Investors*, page 26; March 1, 1957 to December 31, 2003

Siegel concludes that the original, value-type S&P 500 firms have "on average, outperformed the nearly 1,000 new firms that have been added to the index over the subsequent half century" (26). Siegel gives an example which eloquently illustrates this finding. Over 1950-2003, a "growth-type" stock with better per share growth in revenue, dividends, earnings, and price appreciation underperformed a "value" stock inferior in all these categories - but superior in dividend yield. In summary, dividends helped provide steady growth and downside protection and helped avoid the "growth trap" of overvaluation of new additions to the S&P 500. Value stocks provided better returns than the S&P 500 overall.[4]

Siegel quotes Warren Buffett throughout the book and it is obvious that Siegel is a Buffett disciple. His enthusiasm for the practitioner's philosophy is significant as it contributes to the explanation of the value premium. (Much of the academic literature I found focuses on quantifying the difference between value and growth, but often falls short of valid explanations.) Siegel begins the book paraphrasing Buffett's comments as a guest lecturer at Wharton Business School and ends quoting Buffett: "I have seen no trend toward value investing in the 35 years I have practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult" (255).

[4] "The Long-term Returns on the Original S&P 500 Firms" by Siegel and Schwartz goes into much greater detail on the study of the survivors and descendent stocks of the 1957 S&P 500. It details the assumptions as to treatment of changes in stocks (such as mergers, acquisitions, privatizations, spin offs, distributions, bankruptcies and nationalizations). The findings are consistent in direction with other literature on value vs. growth investing although not necessarily the same in magnitude, as detailed later in this review.

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A second theme (well known to Siegel)[5] is that the aging baby-boomers need not worry about the potentially depressing effect of selling stocks in retirement. The emerging wealth of Brazil, Russia, India, and China presumably will finance the aging boomers' stock sales (at the same time, potentially easing retirement costs by selling cheap goods). This theme is based on economic modelling and not the value precepts of the first part. In a recent review in the *Wall Street Journal*,[6] Dr. Robin Brooks of the International Monetary Fund (IMF) challenges the conclusions. He argues that since the richest 10% of the U.S. population owns about 88% of the stock of financial assets in individual hands, it is not likely they will have to sell holdings to maintain living standards. Milton Friedman, a friend and former colleague of Siegel's at the University of Chicago, shares the view that the aging boomers won't face this problem – they can live off dividend income and forced selling of assets will be only marginal.

A third theme is global investing. Siegel summarizes the issues surrounding home country bias and advocates a 40% international weight for a U.S.-based investor. This is below the weight of non-U.S. equities in the MSCI World Index, but well above the weight of the average pension fund asset mix. He notes that growth does not equate to returns; China has had much greater GDP growth than Brazil, but lower investment returns.

Distilling his recent research into three implications, Siegel shares his "D-I-V" directives on page 242:

> **Dividends**: Buy stocks that have sustainable cash flows and return these cash flows to the shareholders as dividends.
>
> **International**: Recognize the forces that will swing the balance of economic power away from the United States, Europe, and Japan toward China, India, and the rest of the developing world.
>
> **Valuation**: Accumulate shares in firms with reasonable valuations relative to their expected growth and avoid IPOs, hot stocks, or other firms or industries that the consensus believes are "must-have" investments.

A recent review of existing value vs. glamour literature was written by Louis Chan and Josef Lakonishok.[7] Lakonishok, Andrei Shleifer, and Robert Vishny[8] are among the first citations in value investment literature, generally preceded only by Fama and French.[9]

[5] Burton, Jonathan. *The Investment Titans: Investment Insights from the Minds that Move Wall Street*. New York: McGraw Hill. 2001. The book outlines Jeremy Siegel's views on demographics/investing, but also has chapters on Josef Lakonishok and Richard Thaler.

[6] Browning, E.S. "As Boomers Retire, a Debate: Will Stock Prices Get Crushed?" *The Wall Street Journal*. May 5, 2005, page A1.

[7] Chan, Louis and Josef Lakonishok, "Value and Growth Investing: Review and Update." *Financial Analysts Journal*. January 2004.

[8] Lakonishok, Josef, Andrei Shleifer, and Robert Vishny. "Contrarian Investment, Extrapolation, and Risk." *Journal of Finance*. December 1994.

[9] Fama, Eugene and Kenneth French. "The Cross-Section of Expected Stock Returns." *Journal of Finance*. June 1992.

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In academic studies of the differences in returns from style investing, the results are fairly consistent, although the explanations are quite different. The studies typically divide stocks into deciles by some value metric such as the book to market ratio, and measure differences over long periods (such as 40 years). Studies include U.S. large cap and small cap, Europe, and Japan. Chan and Lakonishok point out, "A large body of empirical research indicates that value stocks, on average, earn higher returns than growth stocks. The reward to value investing is more pronounced for small-cap stocks. . . . The value premium exists also in equity markets outside the United States." Interestingly, the differences between value and growth investing reported in the literature are in the order of hundreds of basis points, much larger than Siegel's reported differences.

Behavioural finance has attempted to provide an explanation for the value premium. Andrew Lo recently reviewed behavioural literature and put forward a hypothesis which attempts to explain investor behaviour.[10] According to Lo: ". . . Underlying the EMH [Efficient Market Hypothesis] are the assumptions that market participants are rational economic beings, always acting in their best interests and making decisions in an optimal fashion. . . . These assumptions of rationality. . . have come under attack from a number of quarters. . . in particular by psychologists and experimental economists (who) have documented a number of departures from market rationality in the form of behavioural biases, apparently ubiquitous to human decision-making under uncertainty. . . ."

Lo notes the differences between economics and psychology: psychology has its roots in empirical observation and controlled experimentation. Only later are attempts made to draw inferences about the origin of such behaviour. Economists typically derive behaviour axiomatically from simple principles, resulting in economic behaviour that is refuted routinely. Lo's Adaptive Markets Hypothesis (AMH) attempts to reconcile behaviouralists and efficient markets believers. The AMH holds that investors, while they act in self-interest, make mistakes and learn and adapt from them; natural selections lead to evolution in markets.

Overall, Jeremy Siegel's *The Future for Investors* is an important sequel to *Stocks for the Long Run* and a valuable extension of his quest for potentially higher investment returns. His conclusions are consistent with the existing literature on value investing and his explanations for the value premium are probably a significant contribution to this field. These explanations are supported by both the philosophy of the Warren Buffett value school and the behaviouralists. Siegel's findings support a notion that value investors are much more like behaviouralists than economists and that field is a prospective place to look in explaining differences in style-based investment returns.

[10] Lo, Andrew. "Reconciling Efficient Markets with Behavioural Finance: The Adaptive Markets Hypothesis." March 2005, unpublished, but forthcoming in the *Journal of Investment Consulting*. The article is currently available at www.ssrn.com.

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