3rd Quarter 2012 Economic Commentary

BY JEREMY SIEGEL

ARE EQUITIES DYING?

Bill Gross, founder and Co-Chief Investment Officer of PIMCO, laid down the gauntlet. In a widely publicized commentary posted on his firm's website in August, he claimed that the "cult of equity" is dying. Gross claimed the long-term real returns I have found in the stock market of 6.6% per year after inflation is "an historical freak, a mutation likely never to be seen again as far as we mortals are concerned."[1]

But I believe equities are far from dead and Gross's support for his claim is based on faulty data and bad economics. First, he maintains that it is economically inconsistent for stocks to have a real return that is greater than the real growth of the economy. But that claim is incorrect. Even if the economy is not growing at all, capital will receive a positive return just as labor will receive positive wages and land will receive positive rents. The total real return on stocks (which is shown from 1802 in the accompanying graph) assumes that all dividends and capital gains are reinvested in the market. In the real world, investors consume out of the dividends and capital gains, so that the growth of the capital stock (and total stock market values) is not greater than the economy's rate of growth even though the total return on stocks is substantially higher.

Second, Gross implies that the 6.6% return over the last century is freakish and is the result of a singular confluence of events, particularly the shift of return from labor to capital that is not likely to be repeated. First, the 6.6% real return is hardly freakish and prevailed in the U.S. in 19th century as well the 20th. Several years ago some analysts questioned the stock return data that I used before 1871, implying that earlier stock returns were much lower. But new, detailed research, by William Goetzmann and Roger Ibbotson of Yale University, of NYSE data before 1871 shows a stock return of 6.5% per year during a period when inflation was negligible.[2] Furthermore, exhaustive research by three British economists of stock returns from 19 countries around the world from 1900 shows that stock returns dominate by a wide margin every other asset class in every country examined. They conclude, "While the U.S. and the U.K. [stock markets] have indeed performed well, there is no indication that they are hugely out of line with other countries [and] investors may not have been materially misled by a focus on the U.S."[3]

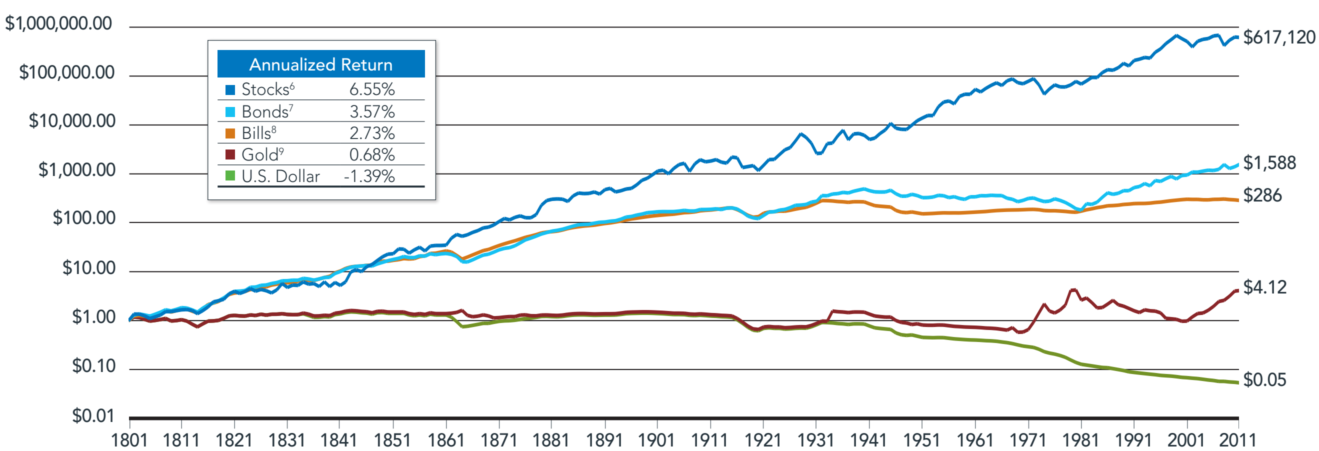
[1] Gross, Bill. "Cult Figures." Investment Outlook August 2012.
[2] Goetzmann, William N., Ibbotson, Roger G., and Peng, Liang. "A New Historical Database for the NYSE 1815 to 1925: Performance and Predictability." Yale School of Management. July 14, 2000.
[3] Dimson, Elroy, Marsh, Paul, and Staunton, Mike. "Triumph of the Optimists: 101 Years of Global Investment Returns." Princeton University Press. 2008.

Finally, Gross's claim that the high stock returns have been boosted by the fall in the share of national income going to "wages *and* salaries" is also wrong. The decline in the wage and salary share of national income can be explained entirely by the sharp rise in benefits (mostly health care) that firms pay to workers. In 1953, the non-wage compensation to workers was only 3% of GDP, but by 2011 it has risen to 10.8%,[4] offsetting the 8 percentage point fall in the wage and salary component that Gross shows over the period.

All this means that Gross's prediction of a 4% nominal return for stocks is far too low. Because equities in the U.S. (and, in fact, around the world) are selling below their historical average price-to-earnings (P/E) ratio[5] of 15, I believe that stocks will very likely match if not exceed their historical return. And if inflation strikes, as Gross fears, I'd much rather be in stocks than bonds. I agree that stocks are not particularly good inflation hedges in the short run, but I believe that in the long run equities have the potential to fully compensate investors for inflation. Look at the total return diagram. Although inflation has reduced the value of the dollar by nearly 95% since the end of the Second World War, this has had no adverse impact on the real returns on equity.

Finally, I had a chuckle when Gross referred to my *Stocks for the Long Run* as an "ill-timed book affirming the equity cult." My book hit the stores in May 1994, and the return on stocks since then has been in excess of 8.3% per year, with a real return very close to the historical average. What was in fact particularly "ill-timed" was Bill Gross's much ballyhooed prediction entitled "Dow 5,000," which he published a few weeks before the bottom of the 2002 bear market, when the Dow Industrials was ready to run from 7,500 to over 14,000.

TOTAL REAL RETURN INDICES [12/31/1802 to 6/30/2012]



Source: Siegel, Jeremy J. *Stocks for the Long Run*, 4th Edition. McGraw Hill Companies: 2008, with updates to 6/30/2012.
You cannot invest in an index.
The source data on the return series for the major asset classes can be found in Professor Siegel's book *Stocks for the Long Run*, 4th Edition. Professor Siegel compiled his own proprietary indexes on each asset class and updates each data series from the book to reflect more up-to-date periods.

[4] Source: U.S. Bureau of Economic Analysis, 2012.
[5] Price-to-earnings ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.
[6] Stocks: The total returns after inflation on the broadest index of stocks available at the time (Stocks-real-total return index: 1802–2011).
[7] Bonds: The total returns on an index on U.S. government bonds after inflation (Bonds-real-total return index: 1802–2011).
[8] Bills: The total returns on U.S. Treasury Bills after inflation (Bills-real-accumulative index: 1802–2011).
[9] Gold: The value of 1 dollar of gold bullion after inflation (Gold-real-price index: 1802–2011).

Investors should carefully consider the investment objectives, risks, charges and expenses of the Funds before investing. To obtain a prospectus containing this and other important information, call 866.909.WISE (9473) or visit wisdomtree.com. Read the prospectus carefully before you invest.

There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

This article was reprinted with the permission of Jeremy Siegel. WisdomTree is not responsible for its content and has reprinted this article to be viewed as informational. The information provided to you herein represents the opinions of Jeremy Siegel and is not intended to be considered a recommendation to participate in any particular trading strategy or deemed to be an offer or sale of any investment product, and it should not be relied on as such. Past performance is no guarantee of future results.

Professor Jeremy Siegel is a Senior Investment Strategy Advisor to WisdomTree Investments, Inc., and WisdomTree Asset Management, Inc. He is also a registered representative of ALPS Distributors, Inc. This article speaks of his research and expresses his opinions and is not to be considered a recommendation to participate in any particular trading strategy or deemed to be an offer or sale of any investment product, and it should not be relied on as such. The user of this information assumes the entire risk of any use made of the information provided herein.

Neither Professor Siegel nor WisdomTree nor any other party involved in making or compiling any information makes an express or implied warranty or representation with respect to information in this article.

WisdomTree Funds are distributed by ALPS Distributors, Inc. WIS004487 10/2013