Rubble Logic: What Did We Learn From the Great Stock Market Bubble?

January 11, 2005

On the face of it, using historical stock returns to forecast for the future seems unimpeachable. It is certainly common, and the method is simple and clear: Analyze stock returns over some long period, and assume future returns will follow suit.

While this method seems reasonable, it can produce strange results if an investor happens to choose the wrong start or end date in his study. The author gives an example of this — using particular extreme end points and then looking at returns over only the next few years — to make the point that forecasts derived from past averages are often backwards. That is, after periods of strong returns, expected returns may actually be lower for the future.

Many investors learned that lesson the hard way when the telecom-technology bubble burst in 2000. In this paper, the author explores some other lessons that investors learned — or what they should have learned — in that crash. Among them:

- Long-term investors should not be 100% in stocks
- International diversification is not a waste of time
- Dividends are good and for some surprising reasons
- Earnings do not grow at 10% a year
- Value wins in the long term
- You cannot trust Wall Street to compare apples to apples
- Timing the market is not all bad
- The general public is full of bored, innumerate gamblers
- Do-it-yourself trading is a bad idea

The author concludes: "As Warren Buffett says, investing is simple — but not easy."

Graham and Dodd Readers' Choice Award 2005
The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. The views and opinions expressed herein are those of the author and do not necessarily reflect the views of AQR Capital Management, LLC, its affiliates or its employees. This information is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein. Past performance is not a guarantee of future results.

Hypothetical performance results have many inherent limitations, some of which, but not all, are described herein. Hypothetical performance results are presented for illustrative purposes only.

Diversification does not eliminate the risk of experiencing investment loss.

Certain publications may have been written prior to the author being an employee of AQR.

This material is intended for informational purposes only and should not be construed as legal or tax advice, nor is it intended to replace the advice of a qualified attorney or tax advisor.