
Letter From The Portfolio Managers

July 2007

What Should You Expect From The Stock Market?



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At social gatherings, when the question comes around to what we do for a living, the next question after that is almost always either: “What should I invest in now?” or “Where is the stock market headed?”

Our answer, to the first question, “It depends,” never seems to fully satisfy the questioner. Yet, it is the right answer. In fact, it depends on a lot of things. Perhaps most importantly, it depends on what the questioner already owns. Does their current portfolio have an appropriate asset allocation? Are they properly diversified, or are there concentration risks and portfolio overlap issues? There are other issues as well: Why are they investing; what is their objective? Are there tax considerations or cost issues? What about their investment experience level?



Rusty Vanneman

In an environment of uncertainty (and one thing we are certain about is that the market is always uncertain), the reply “it depends” is certainly correct.

In the case of the second query, we’re not so certain. Our expectation of how the stock market will perform over any short-term time frame is really more of a guess, an educated guess to be sure, but essentially it is still a guess. That’s why we believe that balanced, diversified portfolios composed of different assets and different managers make sense for most investors.

We do have an opinion on the markets, of course. We digest a lot of outside research, and we analyze large amounts of data in the course of our own research. Armed with that knowledge and our experience as investors, we tilt your portfolios towards those exposures we believe will provide superior risk-adjusted performance. While we think the odds are in our favor, rather than make concentrated bets, we still diversify because we know we could be wrong.

Longer-Term, Expected Returns Are Driven By Three Factors

While no one can accurately predict short-term stock performance, a framework for expected stock market returns over multi-year periods can be developed as a useful guide in formulating a longer-term asset allocation strategy. We’ve covered this ground before, but let’s review the building blocks of stock market returns.

Dividends

The first component of expected stock returns is current income or dividends. Currently, the broad U.S. stock market (S&P 500) has a dividend yield of just under 2%. This compares to a long-term average dividend yield of approximately 4%.

Earnings Growth

The second, and generally most important component, is earnings growth. The historical average rate of growth in corporate earnings is 6%. Not surprisingly, over the long-term, the growth rate of corporate earnings closely tracks the growth rate in the economy. However, globalization has made the growth of foreign economies an increasingly important factor as well. The first quarter of 2007 is a good example. While *nominal* U.S. GDP growth was just under 5%

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(0.7% 'real'), first quarter S&P 500 operating earnings were up 8%+, aided by strong growth in foreign earnings. Robust global growth has benefited U.S. companies and their stocks, and will likely continue to do so.

Valuations

The last building block in creating an expected return for the stock market is the valuation (P/E ratio) the market assigns to those earnings. Over the past 20 years or so, rising P/Es have been a positive source of stock market returns. In more recent years, however, we have seen P/Es contract, and largely for that reason, the stock market has not gained as much as earnings growth would have suggested.

A variety of factors play into valuations such as interest rates, tax rates, transaction costs and regulation. Of course valuations are also driven by so-called "animal spirits." The emotions of greed and fear can push valuations to extreme levels in either direction. However, historically, when valuations have reached extremes, they have eventually reverted back to more normal levels. The Internet boom in the late '90s is a recent example.

Where do We See These Factors Today

Dividends have been below 2% since 1997 and we expect them to remain in that range for the next several years.

The last several years have been extraordinary ones for earnings growth. Up until the first quarter of this year, S&P 500 operating earnings had expanded at double-digit rates for 18 consecutive quarters. As noted, last quarter earnings growth slowed to 8% and Standard and Poor's projects earnings further slowing to 6% in the second quarter and 2% in the third quarter.

We think a deceleration in earnings makes sense given that the housing sector doesn't appear to have stabilized yet. And given that earnings have grown above their historical average in recent years, one could argue for something less than 6% earnings growth over the next several years. But for the purposes of building a long-term stock market return expectation, we will use the long-term average earnings growth of 6%.

Our view on valuations going forward is basically neutral, i.e. on balance we expect no change in P/Es. However, if we were forced to pick direction, we would give a nod to modestly lower P/Es in the years ahead. Valuations remain higher than their long-term averages which makes sense given that the combination of interest rates, tax rates, transaction costs, and regulation also remain low relative to their long-term averages. But the combination of those factors seem more likely to go up than down given the current political climate, and valuations have been trending down of late.

Adding It All Up

Let's add it all up. A dividend yield of around 2%, plus earning growth of 6% with no change in valuations adds up to an expected return of around 8%. This is less than the average return for the S&P going back to the 1920s of 10%, but actually higher than the 7.1% the S&P 500 has returned over the last 10 years.

Factoring In Inflation

Of course, in investing your money, we are not just looking at gross or "nominal" returns but your returns after subtracting inflation or "real" returns. The long-term inflation rate is about 3.4%, so the real long-term stock market return is around 6.6% (10.0% minus 3.4%).

Current measures of inflation are a mixed bag. There are a variety of measures to look at and multiple time frames. Currently, the Consumer Price Index (CPI) is at 2.7%. Core CPI (CPI less food and energy) is 2.2%. In terms of market expectations for inflation, by comparing the yields between regular Treasury bonds and inflation-linked Treasury bonds we see that investors think inflation is likely to be around 2.5%. All in all, our best guess is that inflation is likely to remain in the neighborhood of 2-3%.

If inflation is 2.5%, then our expected real return for stocks is approximately 5.5%. While that is under the long-term average real return of 6.5%, it isn't a poor return.

For sake of comparison, the historical *real* return for long-term bonds is in the neighborhood of 2.5% (again for stocks the average is approximately 6.5%). With current Treasury yields at 5.0% and inflation around 2.5%, the expected real return for bonds is basically in line with long-term averages.

Key Implications for Investors

There are a couple of important implications from all of this. First, stocks should still provide superior real total returns to bonds (5.5% to 2.5%), although their advantage over bonds may be less than normal (6.5% to 2.5%). Second, since the expected real return differential between stocks and bonds is less than in years past, owning bonds to help lower overall portfolio risk and provide a more attractive risk-adjusted return makes even more sense.

Our objective is to build client portfolios that include a broad range of assets, including alternative investments, with the goal of delivering attractive long-term, risk-adjusted returns for an appropriate level of risk – after costs, taxes, and inflation. We may be able to achieve higher returns than the broad market, but using the above facts and figures are helpful for financial planning purposes.

Conference Call

On June 27th, we hosted a conference to provide an overview of our current thinking on the economy and markets. For those who missed it and might want to hear it, it can be found at: http://www.kobreninsightmanagement.com/conference_calls.

Sincerely,



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