

MARKET RETURNS – 1970S AND TODAY

By: Charles S. Bath, CFA

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As I have stated many times, I was very fortunate to get started in this business in 1982. The bull market, which began in August of that year and lasted until 2000, helped make it a wonderful period to be an equity investor. At the beginning of my career, I remember being surprised by the dismal equity returns of the previous periods. Equities were virtually flat for the 14 years ending in July of 1982, which is a very long period of time for so little progress to be made in the equity markets. This had several implications, but primarily an indifferent investor class and attractive valuations. Today's investors seem more discouraged than indifferent, but I look back on that period for clues as to the opportunities available in the market today. On the surface, it might appear discouraging. If we are entering an extended period of flat market returns, equity opportunities would appear limited. However, the analogy I would like to draw is with the narrower time period of 1974-1982. While the 14 year period ending in 1982 was awful, the returns from the lows of 1974-75 were attractive. If March 2009 turns out to be the market low of this cycle, similar opportunities may be available today. If we were to apply the 1970s analogy, simple math indicates that investment opportunities could return to historical norms. To provide an example, let's assume a 16 year period of a flat S&P 500. That sounds like an awful return but remember valuations were a lot higher in 2000. So if we assume the market does return to the peak levels of 2000 by the end of 2016, then the market appreciation from June 30, 2009 would be approximately 7% annually. Add in the dividend yield, and we would have a very normal return for the next 7 ½ years, in that scenario.

Of course, simply doing the calculation does not mean that the market will return to those levels or that the 1970s analogy is even valid. However, in my opinion, if you examine the levels of earnings and valuations in the market today, normal rates of growth off normalized earnings could get you close to the level of earnings in the market in 2006-2007. If you put a normal multiple on those earnings, you could justify the market valuations we first reached in 2000. My estimates may be off by a year or two, but I believe the opportunity remains approximately the same. The way I see it, normal, but not outstanding, investment opportunities appear to be available in the equity markets.

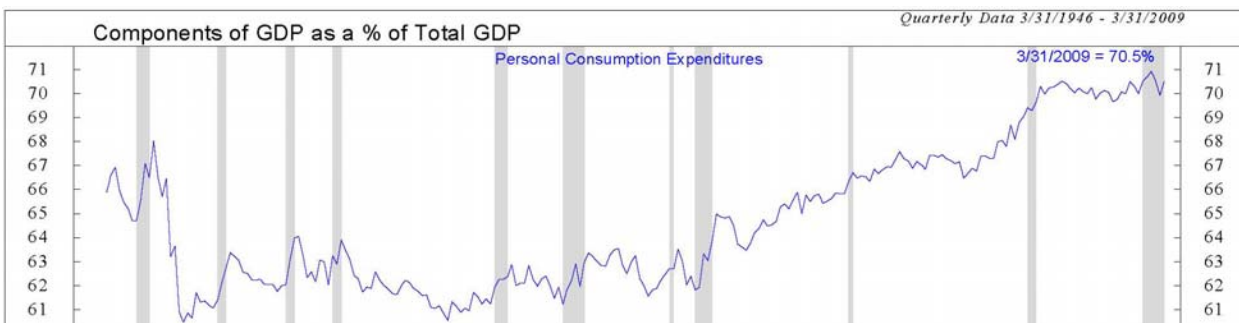
Consumer Debt

Within the equity markets, we remain concerned regarding the health of the American consumer and the effect the consumer will have on the economic recovery. This is an area of the U.S. economy that is facing serious secular issues. The past 25 years have been marked by occasional recessions and recoveries, driven by consumer spending. This consumer spending was driven, in large part, by increased borrowing against higher asset prices. Those assets are no longer appreciating, but the debt remains. Levels of consumer debt seem unsustainable, which is why I believe the market may be too optimistic regarding a U.S. recovery dependent on consumer spending. Below is a chart showing the rise in consumer debt relative to GDP. The increase in the last 30 years is amazing.



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The next chart shows the growth of personal consumption expenditures as a percent of GDP. Note the steady rise over this period. Through much of the 1980s and early 1990s, this could be explained by the normal spending pattern of baby boomers, as they approached middle age. However, now the population is aging, and consumption should shrink from these high levels. While such a correction is normal, it will make it difficult for American consumers to drive future GDP growth.



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This letter is intended to provide an historic framework for our current environment, as well as a sober assessment of the opportunities. Market opportunities will be different in this environment, as the challenges facing the U.S. consumer are daunting. In my opinion, the good news is that valuations have adjusted, so going forward equity investors should have the opportunity for more normal returns for the next several years. As you would expect, that assessment is reflected in our portfolios.



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