

Agree or Disagree: In the so-called new normal, U.S. equities not only will offer respectable returns but also will significantly outperform other traditional asset classes.

AGREE

BY DAVID T. JACK, CFA

The “new normal,” an economic outlook favored and popularized by PIMCO, is an extended period of below-average economic growth in which corporate profits stagnate, interest and inflation rates are abnormally low, and governments play a bigger role in the economy in terms of fiscal and monetary stimulus and more onerous regulatory activities. It is a time of consumer deleveraging, deglobalization, currency disruption, and re-regulation. On the surface, the new normal would seem to describe an unfavorable environment for common stocks. That, however, may not be so.

The return from any investment comes from up to three sources, including income from interest or dividends, growth in the income stream, and changes in the valuation that the market places on the income (e.g., the P/E ratio). Stocks provide all three sources of return, and bonds deliver income and potential valuation change but no growth. Commodities, the current rage, experience speculative changes in valuation because they generate no income and tend to experience long-term price increases comparable to the overall rate of inflation.

How does the new normal compare with the “old normal”? The components of return for the S&P 500 Index by decade from 1960 through 2009 indicate that the “old normal” never existed. Returns ranged from spectacular in the 1980s and 1990s to dismal in the 2000s. In fact, no decade produced numbers near the 9 percent or 10 percent “normal” annual return we have been taught to expect from stocks.

Wild swings in valuations (i.e., P/E changes) account for most of the variation in returns over time. P/E fell at an annual rate of 7.6 percent a year from 1969 to 1979 because beginning P/Es were high and inflation and interest rates soared, and from 1969 to 1979, P/E fell 54 percent (from 15.9 to 7.3). The 2000s saw recurring recessions, virtually no EPS growth, and P/Es falling from the unprecedented peaks of the dot-com bubble.

Another interesting phenomenon is the decline of the income component of returns during the past two decades. This drop is caused primarily by a decline in the payout ratio, which is simply the portion of corporate earnings that are paid to shareholders in the form of dividends. In the 1950s and 1960s, it was normal to pay out about 50 percent of earnings. During the past 10 years, the payout ratio has averaged 30 percent.

This trend will not reverse and is a consequence of the practice of paying corporate managers with company stock. Simply put, dividends reduce the value of stock options. Academic research verifies that the payment of dividends does not impact total shareholder returns but determines the split between capital gains and income. (For example, in “Stock Repurchases and the EPS Enhancement Fallacy” *Financial Analysts Journal* [July/August 2008], Jacob Oded and Allen Michel showed that “the value of an investor’s holdings is invariant with respect to the choice of payout policy.”) Lower dividends mean more capital gains and more valuable stock options.

So, what is the future for stock returns in this low-growth new normal world? Will low 2 percent growth and low 2 percent income result in 4 percent stock returns?

Maybe not. Clearly, the growth component would be expected to be lower than in the past. Research indicates that long-term historical real corporate annual earnings-per-share growth has been about 2 percent less than real GDP growth in developed countries (see, for example, Peter Bernstein and Robert Arnott, “Earnings Growth: The Two Percent Dilution” *Financial Analysts Journal* [September/October 2003]). In the United States, real EPS growth for the S&P 500 has been about 1.8 percent annually since 1950, a period in which real GDP growth exceeded 3 percent annually. In the new normal, given real GDP growth of, say, 2 percent and inflation of 2 percent, is nominal EPS growth of 2 percent all we can expect (i.e., no real growth plus 2 percent inflation)?

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	S&P 500 Return Components					New Normal		
	1960–69	1970–79	1980–89	1990–99	2000–09	S&P 500	10-Year T-Bond	Commodities
EPS growth rate	5.5%	9.9%	4.4%	7.7%	0.6%	2.0%	—	2.0%
Income return	3.2	4.1	4.3	2.5	1.8	5.3	3.3	—
P/E change	-1.0	-7.6	7.8	7.1	-3.3	—	—	—
Total return	7.7	5.7	17.4	18.2	-1.0	7.4	3.3	2.0

Note: Sums are geometrically linked and may not add arithmetically.

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BY GERALD W. BUETOW, JR., CFA

My purpose here is not to be overly bearish toward equities. Rather, I want to objectify the investment decision and portfolio construction process so readers at least can consider an alternative perspective on equity valuations and arguably better risk-adjusted return exposures offered by other asset classes. I am truly agnostic when it comes to investment exposures—I just want exposures that properly balance expected risk with potential return.

To be frank, in my opinion, proper portfolio diversification cannot be found within one asset class alone—certainly not solely within the equity universe. Would the folks talking up “inexpensive stock valuations” in the midst of “a growing global economy” operate according to such a premise? Indeed, many in the investment profession have fixated on the return potential for U.S. domestic equities—in particular, large-capitalization stocks. In my view, the rationalizations behind most of these theses seem to ignore many of the fundamental realities driving global fundamental health. The resulting “fair” equity valuations thus likely fail to fully appreciate the evolving dynamics in equity fundamentals and the resulting risks associated with expected-return computations.

Again, suppose I can excuse the absence of risk considerations with regard to what was until late April a strongly trending market. Of course, given this past month of rising anxiety, one might have expected the clamor for stocks to have eased. Alas, there remains what seems an obviously strong desire to see the momentum continue. Remember that equities, unlike most asset classes, are sold more so than they are bought.

No surprise there. Risky assets—equities in particular—have benefited greatly from the profligate monetary and fiscal policies of the recent past. U.S. monetary authorities have touted the successes of their policies by pointing to the strong performance of equity markets. Setting aside the revisionist nature of these proclamations, arguments that the wealth effect will rejuvenate organic economic growth both domestically and abroad are likely to prove ill derived.

Consider the long and growing list of concerns in regard to the strength of the U.S. economy: Employment participation levels dance with record lows; real wages remain on the decline; residential real estate prices continue to fall (with dire consequences for not only consumer spending but also the financial sector); the output gap remains stubbornly large; regulatory burdens are on the rise. To this list of domestic issues (by no means exhaustive), add international concerns: growing accept-

ance of the likelihood of sovereign debt defaults in peripheral Europe (or restructuring, etc.) and the political fallout of such actions throughout the EU, rising and sustainable inflation (both in wages and commodities) throughout the emerging economies, and persistent geopolitical instability throughout most of the Middle East.

Now, please allow some “what if’s?”—none too unlikely: What will happen if current domestic U.S. monetary and fiscal policies come to an end? What will happen if a default actually takes place in peripheral Europe? What if more unrest in the Middle East causes further disruption of the oil supply? What if China’s current restrictive monetary policy proves too firm or too weak? What if the Japanese economy falters more than most assume following the tsunami? At a minimum, if any of these come to pass, the risk dimension will be dramatically altered. In fact, I would argue that organic growth will be meaningfully constrained. In other words, the macroeconomic backdrop to earnings growth will be severely challenged. Indeed, the very same corporate balance sheets used to justify valuations are likely intended for difficult economic conditions. Most corporate executives appear to have realized that growth will be hard to come by and have prepared their financials to deal with it. Despite what others might want to believe, potential realities of such consequences demand more objective consideration in portfolio construction.

So, where would an investor prefer to be instead of equities? Certainly, the risk-adjusted potential returns of corporate bonds deserve strong consideration. Inflation might be the greatest strike against the class (if unexpectedly onerous inflation were likely in the medium term). I strongly believe that inflation is not an issue, particularly as governmental munificence is reined in. I particularly like lower-rated investment-grade bonds and higher-rated below-investment-grade bonds. These bonds currently have very strong financial support, relative low duration risk, and steady income. Steady real income compares favorably with a theory of equity returns that effectively boils down to “they’ve gone up in the past.”

I also prefer U.S. Treasuries, municipal bonds, and even gold. The risk of deflation, seemingly still the big fear at the Fed, has not subsided sufficiently to be ignored. As risk grows throughout most equity markets, demand for Treasuries is likely to increase well beyond the draw from the current round of quantitative easing.

The same interest rate dynamic makes municipal bonds appealing. Good security selection in this area will

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The regular dividend income component is relatively simple to calculate and is determined by corporate profitability, the dividend payout ratio, and stock valuation. For the S&P 500 today, with a return on equity of about 14 percent, P/B (price-to-book ratio) of 2.25, and a payout ratio of 30 percent, the dividend yield is about 1.9 percent (or 14 percent \times 30 percent/2.25).

So, with 2.0 percent EPS growth and a 1.9 percent dividend yield, is a total return of 3.9 percent the best we can hope for?

No. In this environment, companies will begin to build up huge piles of cash. The 70 percent of earnings *not* paid out as dividends would be enough to support EPS growth of almost 10 percent per year, yet growth is actually only 2 percent. In a slow-growth economy with limited investment opportunities, companies (in the aggregate) will likely use the excess cash to buy back shares, which for the shareholders as a group is effectively an additional dividend. Based on the same profitability and valuation assumptions detailed above, the yield to shareholders would be about 3.4 percent annually. The 5.3 percent “income return” in the table on p. 54 is simply the sum of the regular dividend yield and the “buyback” yield.

From an accounting standpoint, the result of buybacks is to reduce the number of shares outstanding, raising the reported growth rate of EPS and converting the “buyback yield” into capital gains because share prices grow with the higher EPS.

Note that what’s different now is that the low rate of nominal growth greatly reduces the need for corporate reinvestment. The old model, with about 3.5 percent inflation and 3.5 percent real GDP growth, resulted in 7 percent total growth, which is supported by retaining 50 percent of the 14 percent return on equity. The 50 percent paid out as dividends generated a dividend yield to shareholders of about 3 percent and a total return of 9–10 percent (or 3 percent yield plus 6–7 percent growth).

The final return component, P/E change, is unpredictable in the short term but is not a permanent source of return in the long term. P/Es fluctuate but do not exhibit a long-term increasing or decreasing trend. Most experts view current P/E ratios as near the long-term norm, neither extraordinarily high nor low. The series is mean reverting, currently hovers near the long-term mean, and is not likely to be a significant source of incremental future return (positive or negative) as we grind our way through this new normal.

So, the new normal, with its low expected growth and inflation, features a minimal need for corporate reinvestment and a path to respectable stock returns of 7.4 percent. In a world of 3.3 percent bond returns (with substantial downside risk), wildly fluctuating commodity prices, and expected long-term return of 2 percent, what’s wrong with 7.4 percent? **■**

David T. Jack, CFA, is a product specialist at Snow Capital Management in Sewickley, Pennsylvania, and a member of the CFA Society of Pittsburgh.

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be handsomely rewarded. Munis have done very well thus far this year, and investors should continue to take advantage of any renewed bearish call-driven stampede for the exits. The secular fundamentals of gold also compare well with the risk and return of most equity markets. Investors can take advantage of the oscillatory nature of gold and continue to add to their exposure in a tactical and opportunistic manner. Indeed, being nimble—tactical, as it were—should pay off handsomely in the forthcoming quarters and years.

One final asset class to prefer over equities is real estate, primarily REITs and residential. The risk-adjusted return potential across the REIT market is better than that available for most aggregate equity exposures. And for cash-heavy portfolios, the residential real estate market offers several opportunities. Obviously, this last preference does come with practical limitations, but adding exposure to this asset class over the next year or so should prove advantageous over the coming decade from both a risk and

a wealth-accumulation perspective and should produce superior results relative to current equity valuations.

In sum, several asset classes offer risk-adjusted opportunities superior to those implied by the valuations throughout most equity markets, but this situation may not hold true in a few short months. The capital markets react swiftly, and new tactical opportunities arise quickly. Investors need to remain objective and never put too much faith in numerical estimates of expected return that are more often the result of models based on poorly considered assumptions and questionable inputs. A better approach is to remain ever mindful of the potential return *and risks* inherent to any individual investment decision while always being keenly aware of its impact at the portfolio level. Prudent and disciplined wealth management should always be implemented within the framework of broad asset-class diversification. **■**

Gerald W. Buetow, Jr., CFA, is chief investment officer at AFAM/Innealta Capital.