



# Financial Alternatives

Integrated  
Wealth  
Management

Jim Freeman, CFP® / Chris Jaccard, CFP®

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## Financial Summary for the First Half of 2009

The market volatility of 2008 continued into 2009. After a rebound at the end of last year, the S&P 500 Index dropped to a new low of 676 on March 9<sup>th</sup>. It then began a furious three-month climb and reached 946 on June 12<sup>th</sup>. When we began this newsletter the market had fallen to 881 but as of July 16<sup>th</sup> it is back up to 940. The overall environment has improved, yet plenty of potential problems remain. Highly significant questions include when the housing market will bottom, the longer-term impact of the government stimulus and policy actions, and whether investors will remain cautious in the years ahead.

When the market bottomed at 676 on March 9<sup>th</sup>, the 10-year normalized price-to-earnings (P/E) ratio of the S&P 500 was 11.71. With the S&P 500 currently trading around 900, the 10-year normalized P/E ratio is close to the historical median of 16.

What, if anything, can the 10-year normalized P/E ratio of the S&P 500 tell us about future stock returns? We will explore that question in this quarter's newsletter. We will also review what we plan to do if the market retests the March lows or resumes its climb. Lastly, we will discuss the ever-present risk of inflation since this has been a hot topic in the news lately.

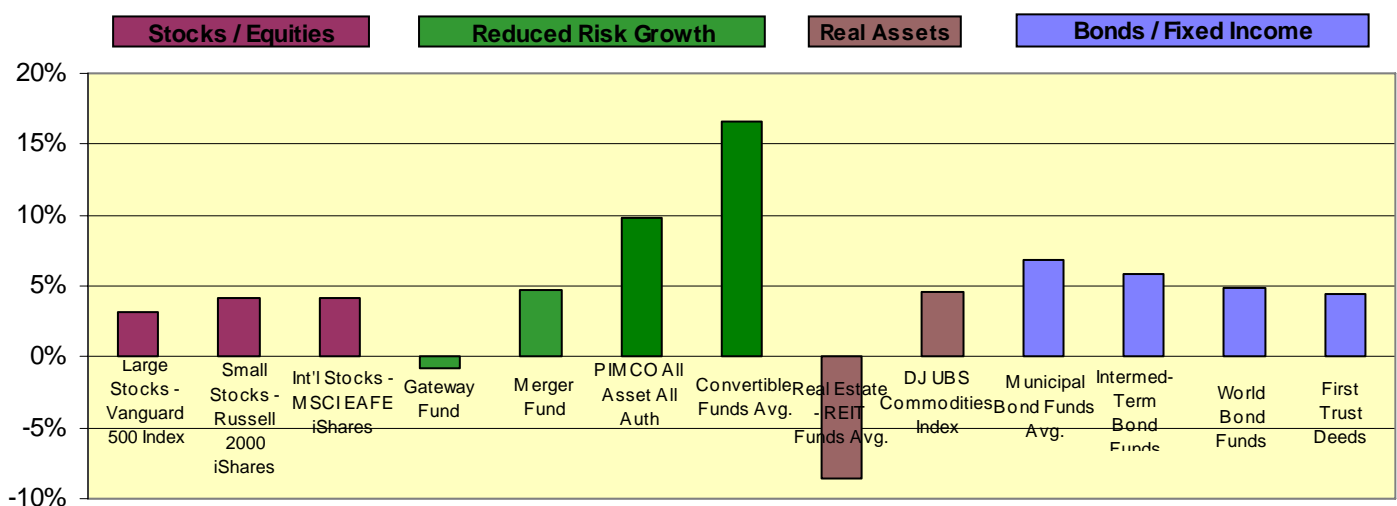
## Can 10-Year Normalized P/E Ratios Predict Future Stock Returns?

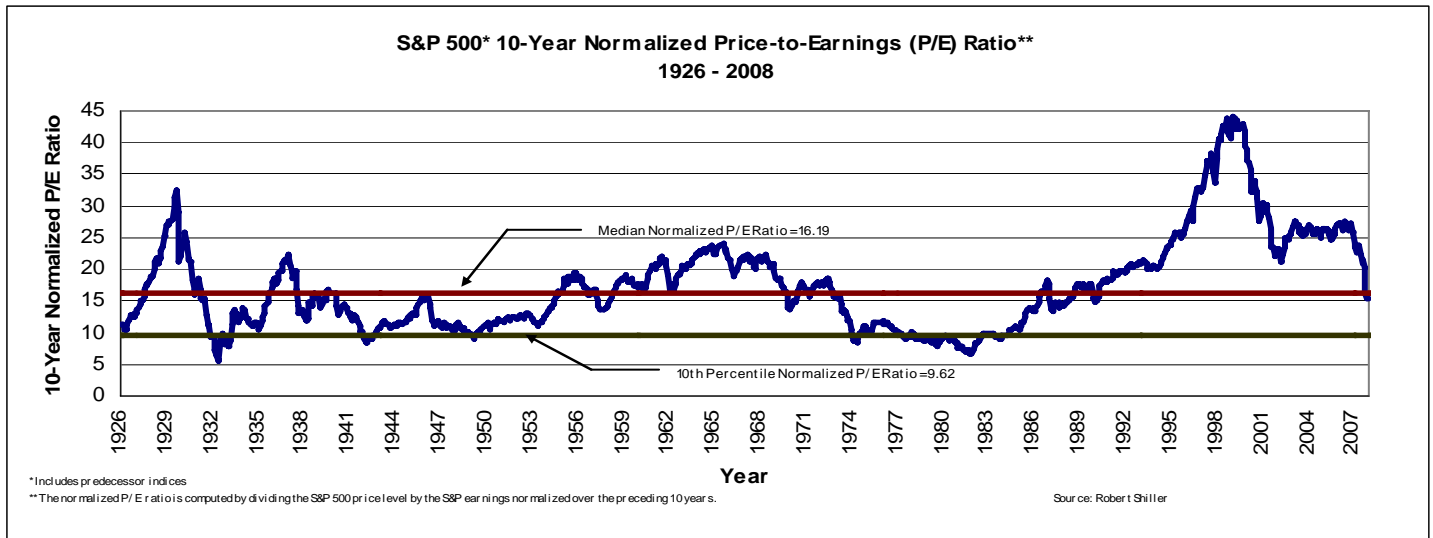
Many financial advisors look at current P/E ratios when determining the amount of equity to hold in client

## Executive Summary

- The S&P 500 10-year compound annual return ending in 2008 was -1.4%. This was the worst 10-year return during the period of 1926 through 2008.
- The current S&P 500 normalized P/E (Price-to-Earnings) ratio is close to the long-term historical median from 1926 to 2008. This is lower than the P/E ratio has been over most of the last two decades.
- Low normalized P/E ratios at the time of purchase have historically been a determinant of higher than average 10-year compound annual returns.
- The high P/E ratios of the past two decades are one of the reasons we have held a significant portion of our client's portfolios in lower risk investments during this time.
- S&P 500 total returns could be significantly better over the next 10 years.
- Expect stock market volatility to continue and don't be surprised if March lows reoccur.
- We will look to reduce growth-oriented equity investments if the S&P 500 reaches the 1,100 range and increase growth-oriented investments if it drops to 680 and below.
- Inflation over the next two to four years will likely be less than many expect, but over the longer-term, inflation remains a serious risk.
- We will continue to balance the risks of inflation and loss of principal as we adjust our client portfolios.

## 2009 Short-term Returns (Year-to-date January 1 - June 30)





portfolios. To understand the importance of P/E ratios, we will discuss 10-year normalized P/E ratios and historical S&P 500 returns.

The normalized P/E ratio is computed by dividing the S&P 500 price level by the S&P 500 earnings “normalized” over the preceding 10-years. Normalizing earnings simply means that the earnings are averaged over a 10-year period. Earnings fluctuate widely on a year-to-year basis but they tend to smooth out over time. This method of normalizing earnings can also be viewed as an attempt to estimate “sustainable” earnings.

### Analyzing Historical 10-Year Normalized P/E Ratios

The graph at the top of this page shows the 10-year normalized P/E ratio from 1926 to 2008. The solid red horizontal line at 16.19 is the median normalized P/E ratio over this entire time period. The solid green horizontal line at 9.62 is the bottom 10<sup>th</sup> percentile, illustrating that historical P/Es were below this level just 10% of the time.

Notice how much time the P/E ratio has spent above and below the median over the decades. As you can see, in 1929 the P/E ratio was extremely high before the stock market crash and extremely low after the crash. For the most part, after the great depression and during World War II the P/E ratio remained below the median. In the mid-fifties it moved above the median and remained there until the early seventies and the severe bear market of 1973/1974. After this bear market, the P/E ratio remained far below the median for the rest of the seventies and most of the eighties. In the early nineties the P/E ratio moved significantly above the median and peaked at the height of the tech bubble in 2000 before finally dropping below the median last year for the first time in almost twenty years.

### Correlating Normalized P/E Ratios to Future Stock Returns

Now let’s turn to the table on page three and see what normalized P/E ratios can teach us about future stock returns. In other words, is there a correlation (or predictive

relationship) between 10-year normalized P/E ratios and subsequent stock returns?

The table indicates such a correlation. This data shows the results of measuring every 10-year return period from 1926 to 2008 and then grouping these 10-year periods into one of four groups based on its P/E ratio at the beginning of the 10-year period. The four groups consisted of P/E ratios below 12, 12 to 16, 16 to 20, and above 20. The results are interesting. The subsequent 10-year compound annual returns were substantially higher when P/E ratios were lower at the beginning of the 10-year period. When P/E ratios went up, future returns tended to go down and vice versa.

It’s interesting to note that the last 10-year return period ending in 2008 was the worst 10-year period ever between 1926 and 2008. The 10-year compounded annual return for the decade was -1.4%. This makes sense because the P/E ratio in 1999 (the beginning of the period) was at an all-time high. P/E ratios are currently around the long-term median. With the P/E ratio currently around the median, it is a reasonable to assume that the next 10-year period will end up somewhere around the long-term averages.

However, we must realize that using 10-year normalized P/E ratios to predict future stock returns is not science and that anything can happen in spite of past trends. Likewise, the future is by definition uncertain and many events on the world stage influence investment returns for better or worse. We must also be careful when working with very long-term historical data because there are always exceptions to any rule or trend. If we look back at specific time periods, we will in fact find multiple 10-year periods when low starting P/E ratios produced below average 10-year returns and when high starting P/E ratios produced above average returns.

In our opinion the predictive value of P/E ratios is strongest when P/E ratios are at extreme lows or extreme highs. The predictive value of normalized P/E ratios on

### S&P 500 10-Year Normalized P/E Ratio & Subsequent 10-Year Compound Annual Return

10-Yr. Normalized P/E Ratio	Below 12	12 to 16	16 to 20	Above 20
Avg 10-Yr Compound Return	14.88%	12.91%	8.50%	4.68%
Range of Historical Outcomes:				
75th %	17.11%	16.50%	10.00%	7.74%
50th %	15.59%	13.11%	8.42%	4.41%
25th %	14.32%	9.33%	6.63%	2.20%
Number of 10-Yr. Periods	26	16	17	15
Average Equity Risk Premium*	8.25%	7.94%	4.14%	-0.79%

\* For any given 10-year period, the Equity Risk Premium is the compound annual return on the S&P 500 (with dividends reinvested) minus the compound annual return on Long-Term Government Bonds. Calculated using data from Ibbotson Associates.

Data from 1926 to 2008

Source: Gibson Capital, LLC

long-term returns is much lower when P/E ratios are in more normal ranges.

#### Most Investors Do Not Use This Information

It is often difficult for investors to take advantage of low P/E ratios because low P/E ratios are normally caused by recessions, bear markets, fear, and panic. It is during these times that many investors are most fearful of stocks and are in fact selling them – thus causing the lower than average P/E ratios.

The opposite is also true. When P/E ratios are above 20 it is almost always after stocks have had very strong performance, and people are pleased with their results. During times like these, greed often sets in and most investors want to buy more stock – thus causing even higher than average P/E ratios.

#### Returns for the Near Future

In summary, lower market P/E ratios have historically led to higher subsequent 10-year compound returns on average and vice versa. Since today's P/E ratio is close to the historical median this information may indicate that a repeat of the dismal returns of the past decade is unlikely to occur in the near future.

The high P/E ratios of the past two decades is one of the reasons we have held a significant portion of our client's portfolios in lower risk investments during this time.

#### Short-Term Market Forecasters and Our Strategy

As is always the case, some market forecasters are predicting that the market will once again test the March 2009 lows; while others predict that the market will resume its upward trend and reach 1,000 to 1,100 by year-end or early next year.

One investment advisor who we have previously quoted and have a lot of respect for, Jeremy Grantham, said he would not be surprised to see the S&P 500 continue its

climb up to 1,000 to 1,100 before dropping and ultimately retesting the March lows if the economic recovery turns out to be weaker than most people expect. You can read Grantham's full quarterly letter entitled, "The Last Hurrah and Seven Lean Years" at [www.gmo.com](http://www.gmo.com).

Time will tell what ultimately happens. Regardless of which scenario unfolds, in our view it is most important to have a plan of action ready for either scenario. Our plan of action will be roughly as follows. If P/E ratios were to climb up to 20 (about 1,100 for the S&P 500), we would reduce growth-oriented equity investments. If the P/E ratio on the other hand were to fall below 12 (around 680 for the S&P 500), we would increase

growth-oriented investments.

In summary, we pay attention to these valuations and attempt to reduce portfolio risk and equity exposure when P/E ratios are higher and add to equity exposure when P/E ratios are lower.

#### The Risks of Inflation for the Near Future

There has been growing press coverage recently regarding the risk of rising inflation. Most coverage paints a negative or even dire inflation portrait, with many pundits focused on the near-term inflationary implications of government spending and the resulting deficit surge.

However, other objective analysis and research builds a strong case that resurgent inflation is likely further off, perhaps two to four years, due to a variety of factors that alleviate inflationary pressures. These factors include the weak economy, high unemployment, and shorter work weeks with reduced wages, unused industrial capacity and a surging savings rate that also reduces consumption. With greatly reduced demand for most goods and services, most businesses are unable to increase prices. Given all these factors, some economists warn of the potential for modest deflation.

While inflation may stay in check in the short-term it is always a serious risk in the long-term.

#### Two Major Risks to Your Portfolio: Inflation and Loss of Principal

Investors face at least two major risks to their portfolios - inflation and loss of principal. Given the housing/credit/financial crisis of the past year, investors are only too well-acquainted with the risk of loss to their principal. Many have seen the balances of their stock and mutual fund holdings reduced. Inflation risk, however, is often overlooked since its effect is typically less visible and doesn't generate as much press coverage.

We've all experienced inflation firsthand; think back to how much you paid for your first car or how much it cost to fill up your gas tank ten years ago as compared to the current cost. That is inflation at work.

The graph below demonstrates the corrosive damage of inflation over time. Even "modest" inflation is a major risk to your portfolio. At 4% inflation per year, costs double in about 18 years, while at 6% inflation costs double in about 12 years and quadruple in 24 years! Note that at 6% inflation over 30 years, each \$1,000 would only be worth \$174 in inflation-adjusted purchasing power. Consider that in the past, some expenses including education, healthcare, and energy have even exceeded 6%.

### **A Diversified Portfolio Balances the Risks of Inflation and Loss of Principal**

Even though "low-risk" investments such as CDs, money markets, and government bonds protect against loss of principal, they are more susceptible to inflation risks long-term because of their lower fixed rates of return. For example, assume you own a CD that currently yields an annual rate of return of 2.0%. If the current inflation rate is 3.0%, after one year your actual rate of return is -1%. You have not lost your principal, but you have lost purchasing power because of the increased cost of goods and services. These small yearly losses add up to a tremendous loss in purchasing power over the decades. If inflation accelerates, the loss of purchasing power can accumulate at a rapid rate.

More volatile investment vehicles, such as real estate, stocks, and commodities, have historically provided a better long-term hedge against inflation because of their higher long-term historical rates of return. However, these investments are more susceptible to short-term losses of principal and these short-term market moves can unnerve investors.

In March many investors sold stocks in an effort to avoid loss of principal risk just as the market was bottoming and loss of principal risk was at its lowest level in years (the market was getting cheaper). Some moved sale proceeds to cash accounts and certificates of deposit that are paying next to nothing, thereby tremendously increasing inflation risk.

By creating diversified portfolios, we attempt to balance the risks of inflation and loss of principal. Balancing risk factors, with your personal financial circumstances in mind, is our goal in creating diversified portfolios.

Our portfolio balancing strategy is based on broad diversification into a variety of complimentary asset classes; many investments "zigzag" differently from one another so that gains in one area often compensate for losses in another. In a similar fashion, multiple asset class diversification helps reduce both inflation risk and loss of principal.

We also make periodic strategic rebalancing adjustments in an effort to take advantage of market fluctuations and cycles over the long-term.

### **Summary**

Current S&P 500 P/E ratios are around median historical levels. Returns over the next 10 years should be better than the last 10 years. Still, don't be surprised if market volatility continues and we once again test the March lows in the short term.

We will look to reduce equity allocations if the S&P 500 reaches the 1,100 range and increase equity allocations if it falls to the 680 and below range.

We will continue in our efforts to balance the risk of inflation against the risk of loss of principal by adjusting our portfolio allocations as market conditions reveal themselves. We will continue to structure portfolios in such a way as to generate income (or portfolio paychecks). Investors thereby benefit from relatively consistent income regardless of whether stock prices are rising or falling.

As always, we encourage you to call anytime with questions or to apprise us of changes that may affect your financial objectives. We hope you are doing well. And finally we'd like to once again thank so many of you for favorable introductions to new clients.

*Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.*

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### **Financial Alternatives, Inc.**

**7734 Herschel Avenue / Suite L  
La Jolla, CA 92037  
Phone: (858) 459-8289  
Fax: (858) 459-8258**

**[jim@financialalternatives.com](mailto:jim@financialalternatives.com)  
[chris@financialalternatives.com](mailto:chris@financialalternatives.com)**

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