

~~DOW 5000~~

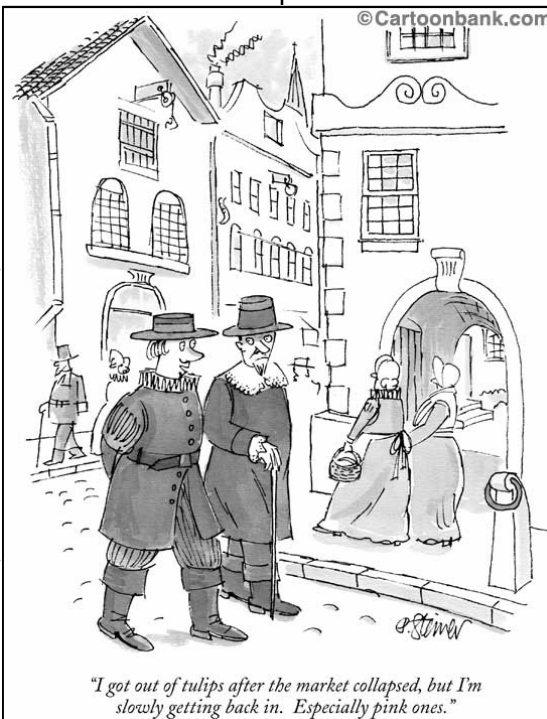
Let's ignore (okay, savor quickly) for a moment the "fall rally" as it occurred as we were going to press, which due to the hellaciously more complicated task of sorting through quarterly corporate disclosure, was frankly about a month ago. This modest upfront caveat still only takes a wisp of steam off the ensuing argument.

We are trotting out the red circle again (DOW 36,000...not!) because over the last few months there seems to have been a lot of attention drawn to the argument that "the market is still overvalued by 50%." We have seen this as recently as the Dow Jones Industrial Average at 7300, so that will be our working point for price.

A variety of arguments that are interesting and essentially correct at 11,000 on the Dow may still be interesting at Dow 7300, but not necessarily correct. That is the primary point of this piece as we go through the arguments presented for Dow 5000, which effectively sum up to the importance of the "starting point" at which one measures the future performance of stocks on an absolute and relative basis. We think that 7300 (or 8300), represented, at the very least, a "decent" starting point at which stocks can very reasonably generate mid to high single digit returns for the intermediate to long-term future without any academic heroics, and that will "dust" the ten-year Treasury return of 4.6%.

The general premise for our argument will be familiar to

clients and regular readers: who knows where the heck markets are going? To be fair to the Dow 5000 viewpoint, "anything" is statistically possible. However, successful investment requires the assignment of probabilities to the entire spectrum of potential outcomes and the history of financial markets and an enormous amount of academic research has clearly shown two things: people are not very



good at predicting the future and extreme outcomes that have a very small probability of occurring tend to be grossly over-exaggerated by price and mental attachment. This suggests that while it is possible that worldwide equity markets and most of their economic constituents are in the early innings of a ten-year Japanese style deflation debacle, it is as unlikely as the possibility that the temporary \$4 billion valuation of Joe's I-Bank.com was indicative of the inevitability of Joe relegating Citibank to a corner Five-and-Dime. (That's Elliot Spitzer's apparent role.) The argument with which we are comfortable is that in this market there are more than enough businesses being priced at severe discounts to conservative estimates of fair value so that we are more than compensated for the risk that the Dow 5000 argument is right, and history has

shown that the value of a "world's smartest man market call" has a statistically insignificant probability of consistently being worth more than the paper on which it's written.

So where does a Dow 5000 come from? While not copyrighted, we have traced a good chunk of the backdrop from the published work of Rob Arnott and First Quadrant, a

quantitative money management firm also based here in sunny Los Angeles. The big press we can attribute to extensive paraphrasing of Arnott's work in commentary from William Gross, the lead seer of the fixed income firm of Pacific Investment Management or PIMCO. Arnott published "The Death of the Risk Premium" in mid 2000, followed by "Does Dividend Policy Foretell Earnings Growth" in 2001 and finally with "What Risk Premium is Normal" in 2002 with noted financial thinker Peter Bernstein. (Check out FirstQuadrant.com and Pimco.com) Now these are very smart guys who have yards of published financial papers behind them, and we have about three thousand words and a mixed audience of layman and practitioner, so please couch any vehement responses in this light and feel free to continue this discussion by phone or email.

The sophistic gist of the Dow 5000 case is reasonably straight-forward: the major components of the mythical double-digit return of stocks over the past 74 years (and longer depending on whose data you are using) have been a giant move from a very low starting point of valuation to a very high level of valuation, and a relatively high dividend yield over most of that period, beginning with a yield of 5.4%. Dividend growth, which is being used (erroneously) as a proxy for corporate earnings growth over that 74-year period, has been barely positive after the effects of inflation. Therefore, if you take today's 1.9% dividend yield on the S&P 500 and add to it a 3.0% growth rate (2% inflation plus the 1% net-of-inflation dividend growth rate), you are only getting an expected return of 4.9%; and therefore, the risk premium that the equity investor is paying is insufficient to compensate an investor for the self-evident vagaries that may plague the stock market in the future.

One point is somewhat self-evident: directional changes in valuation have the largest effect on the rate of return to be achieved by an investor from the selected starting point. Here is a position on which we agree: it is folly to expect that P/E ratios or whatever valuation measure you would like to hang your hat on will effectively triple over the next 20-year period and, therefore, within the context of a low inflation environment, mid to high single digit nominal equity returns are perfectly respectable.

Here's where our opinions differ. The first problem in much academic research and the Dow 5000 topic in particular is a focus solely on dividends as a proxy for value creation in equity ownership. Let's start with the obvious problem of the Gordon Dividend Discount Model that is presented as the main support for an overvalued

stock market: Berkshire Hathaway has never paid a dividend and yet is worth \$112 billion. Clearly, dividends are not the sole basis for an estimation of the value of a stock, but an awful lot of academic research is based upon this theory because payouts are a matter of public record. When you are trying to develop a coherent academic theory involving 74 years and tens of thousands of companies that have come and gone over that time period, you do what you can.

For the record, Nobel prizes have also been won on the basis that dividend policy has zero correlation with the valuation of businesses (go have some fun on the internet with Modigliani and Miller), which leads to our assessment that the key drivers of valuation are very simply how much free cash flow a company generates today, estimates of how this cash flow will be reinvested in the future, and at what growth rate. Due to space constraints, we would highly recommend you check out the Applied Finance Group work at AFGView.com, which has some wonderful and mostly readable theory on why this is the DNA of financial life, as we know it. Practically speaking, if a company has a cost of capital of 10% and can intelligently reinvest cash next year at a 15% rate, why on earth would an investor want to be paid a dividend, particularly in a low interest rate and inflation environment? Also, what about companies in the early stages of life who are in a negative cash flow mode and in no position to pay out a dividend? (Answer: not all are worthless.)

Herein lies the secret of why equity returns are much higher than implied by a simple dividend payout plus growth-based theory. A bond is not valued by "current yield" or the coupon divided by the current price. The value involves modestly complex analysis, which includes assumptions on the reinvestment of the coupon received and thus derives a "total return." The wealth creation possible in intelligent equity selection is based upon the same wondrous principal: if one can buy a business that generates cash that can be reinvested intelligently in growth, the eighth wonder of the world – compound interest – starts kicking in with huge numbers. This is completely ignored by the dividend arguments suggested in the Dow 5000 valuation gospel and only somewhat speciously this is where the entire issue should end.

Relating this to the drivel one is reading today about "dividend policy", the obvious fact of the matter is that a large part of corporate America and the institutional investment community have ignored these facts of life for years in a desperate attempt to achieve and support unsustainably high reported earnings growth targets. As a

result, enormous sums of money were invested in schemes that achieved little or no return and thus destroyed shareholder value. The clamor for dividends should be examined in its true light as possibly the only institutionally acceptable way to put a band-aid on the real problem: how can “stakeholders” ensure that management reinvests their money intelligently? In other words, if we force companies to give us part of their free cash flow every year, it will restrict their ability to do dumb things with the money on an even grander scale. This is the appropriate argument to be made on behalf of both stock and bond investors as fixed income people have been as badly mauled by corporate fraud as equity holders.

There are a number of other flaws to mention briefly in the dividend-based view of the world. Let’s assume there is validity in these arguments and frankly there is some. (“Stocks” overall are still not cheap on a grand sweeping scale.) It is a simple fact the taxation of dividends at both the corporate level (on reported earnings) and then again by the receiver of dividends has created a dis-incentive to pay out dividends as cash over the past twenty years, compared to other corporate finance measures such as share repurchase. For better or worse, there has been a definitive move in this direction, which clearly skews the growth of dividend trend data downward. On this previously noted basis, right or wrong, it also seems reasonably obvious that a bird in the hand (pay dividends) compared to the promise of multitudes in the bush (retain earnings for growth) has cyclical rather than secular written all over it. It now seems obvious that we are in for a period of much higher dividend payout ratios, which will skew valuation work based mostly on dividend payout higher over the next decade. So the missing dividend may yet be found in upcoming years.

The S&P 500 is invariably used as a proxy for the market with its dividend yield of 1.9%. The fact is the S&P is a tricked-up pony whose creators drank the proverbial Kool-Aid in the late 1990s and stuffed it with what were considered the representative large cap growth stocks of the era, the net effect of which was to trend the S&P dividend yield lower. A simple screen of the 1000 largest companies in the U.S. (embarrassingly done when this piece was started a month ago) produced an average dividend yield of 3.3%, which somewhat dents the Dow 5000 argument as presented, so “average” is in the eyes of the beholder.

While we are in the data-mining mode, somehow in the last couple of years pre-1925 data has been creeping into investment literature to help examine longer run equity returns. Suffice it to say there is a fair amount of controversy these days as to accounting treatment in regard

to all sorts of issues. One should remember that only in the last 20 years did corporations have to do ANY accounting for healthcare and pension liabilities, and the open-ness of corporate books was not even a topic that was publicly discussed. It seems fair to say that the longer one goes back, the more difficult it is to make comparisons with today’s world, which makes S&P’s decision to create a “core earnings” measure little more than a marketing sham, as their inability to derive a history of the number makes it impossible to weight its importance in comparing valuations 20 years ago. While people dismiss history at their own peril, go back and read some of Abe Briloff or Ben Graham’s books detailing the accounting chicanery employed over the past century and ask yourself the question: were “earnings” really better then?

There is also the issue of taxes. An interesting and recent piece in the Financial Times supported by academic data from Mssrs. Julian Van Erlach and Christophe Faugere, discussed historical stock and bond returns. Their work suggests that commonly used stock and bond returns (10.7% and 5.3% respectively) over the long run are both overstated. When adjusted down by calculations, the risk premium of stocks over bonds remains unchanged. This is attributed to the point we raised earlier: stocks are a growing annuity stream while bonds are fixed. They also note that taxes can and do play a huge role in return calculations and this further gives the nod to the tax-efficient investment strategy as it levers the mathematics of compounding.

The main issues in equity valuation always rewind to the same principles: focus on the cash generated instead of GAAP earnings; watch and measure what management is doing with the money, understand the balance sheet and avoid being terribly optimistic about what the future looks like as far as projected growth is concerned.

The trick, of course, and one that is essentially implied by the Dow 5000 viewpoint, is that in a highly competitive, mostly free market, it is extraordinarily difficult to find and maintain businesses that can intelligently grow for long periods of time. Thus, financial history is the testament to the inevitable mediocrity of most businesses. However, you don’t have to own every stock and thus be doomed to average-ness: only mega-institutions like CALPERS are forced to own all 12,000 publicly traded equities. It’s as if Michael Jordan should not have been encouraged to play basketball at an early age because the odds were he would turn out to have a jump shot like...mine. To restate a previous argument, the probability of being able to find 25 or 30 businesses that are materially undervalued and thus

possess the ability to deliver above average returns in the future has materially increased over the past four months as prices came down. First Quadrant's argument of the inevitability of upcoming poor equity returns with the Dow at 11,000 was dead on the money in the year 2000. Using the same argument in late 2002 after nearly a 40% decline from the peak has a much, much higher probability of being wrong.

The other major argument (and possibly THE somewhat self-serving argument) suggested by the Dow 5000 movement is the attractiveness of bonds vs. stocks. The world's largest mutual fund manager title passed to PIMCO in late September, taking out the last "can't miss" investment opportunity, the Vanguard S&P 500 index fund (ring bell here for contrary indicator). One cannot help but think this is a particularly timely issue.

As recently well noted by Jim Grant, of Grant's Interest Rate Observer, bonds are by no means a free lunch. Bonds are publicly traded securities whose prices in the near and often intermediate term are subject to the whims and fancies of public imagination just like stocks. They are also brutally constrained more so than stocks by the mathematics of price and coupon. Let's paraphrase Grant's math for a moment: the current 10-year Treasury bond was recently quoted at 106 7/32, to yield 3.62%. Let's have a brief look at the following what if table:

Current Yield and Price: 3.62%	106 ⁷ / ₃₂
If priced at a 4% yield:	103 ¹ / ₃₂
If priced at a 5% yield:	95 ⁵ / ₃₂
If priced at an 8% yield:	75 ¹⁷ / ₃₂

We personally think that a return to 8% ten-year bonds, which has been seen in the last decade for those whose financial memory only extends back to three days worth of CNBC, is far-fetched. However a 5% yield within the next two years can certainly be argued with reasonable intellectual vigor, and our guess is that would be an unpleasant surprise for the hordes running for the apparent safety of low single-digit yields. As noted by Grant, non-corporate bonds today in many ways reflect a mindlessness in which no price is too high to pay for an asset that has not gone down, which is the mirror image of no price is too high to pay for exposure to the Internet revolution.

It has been postulated that the bonds vs. stocks argument is further buttressed by noting the attractiveness of

corporate bonds, a position with which we frankly agree. However, if the corporate bond play works to a large extent, then it de facto erases the "Japanese style deflation stock debacle" which is the economic scenario that belies a ten-year equity return of a low single or zero digit return. All of which argues for an intelligent asset mix between stocks and shorter-term corporate bonds.

Clients and regular readers know we have been far from Pollyanna-ish over the past five years and agree to a degree that the current environment for equities is not like shooting fish in a barrel. We are most likely about to close our first materially down year in decades and there is nothing amusing about that statement. As is almost always the case, taking extreme portfolio positions on the basis of extreme forecasts of the future is a recipe for looking silly at best and causing severe financial harm at worst. It is absolutely correct that stocks do not always outperform bonds and the horse race between asset classes is highly dependent upon the start and finish dates. However, the general debacle in stock prices over the past three years for many investors and many stocks has tilted the probability of our view of stocks outperforming bonds over near, intermediate and we will toss in the long run, which should not be that unusual a statement.

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December 2002

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