



**WHY THIS DECADE IS SO DIFFERENT FROM THE '80S AND '90S
IT INVALIDATES MUCH OF THE CONVENTIONAL WISDOM OF HOW TO SAVE AND INVEST**

- 1) US Stocks and US bonds are the two-legged stool that have traditionally been entirely relied upon to get people to their investment goals.**

That's fine as long as both assets are performing in line with their expected rates of risk/return, based on their historical averages. This decade should see both legs wobble given the probability of low returns ahead.

- 2) In 2000, US stocks entered a long-term, Secular Bear Market that's likely to last until about 2015.**

The market is always in either a Secular Bull or Secular Bear Market where stocks either do very well or very poorly for periods of between 15 and 20 years.

	<u>1895-1914</u>	<u>1914-1929</u>	<u>1929-1949</u>	<u>1949-1966</u>	<u>1966-1982</u>	<u>1982-2000</u>	<u>2000-???</u>
No. of Years	19	15	20	17	16	18	15?
Stock Return	-40%	604%	-55%	493%	-19%	1270%	???
Super Bull/Bear	Bear	Bull	Bear	Bull	Bear	Bull	Bear

- 3) Stock returns come from four components—and they imply a *best-case* expected return of 5.8% per year going forward. With multiple contraction, the return is likely to be negative.**

The long-term average return for stocks of **10%** can be broken down as follows:

- 1) **Dividend Yield:** Over the last 77 years, dividends contributed **4.5%** per year. Rates are currently **1.8%**. At the start of the last Super Bull (1982), stocks yielded 5%.
- 2) **Multiple Expansion:** Over the last 77 years, multiple expansion (increases in the market's P/E) contributed **1.5%** per year. The S&P 500 P/E has ranged from 7 - 35. It peaked in 2000 at 35, and it's currently 22. At the start of the last Super Bull (1982), the P/E was 7.
- 3) **Real Growth of Earnings and Dividends:** Over the last 77 years, real growth in earnings and dividend has been **1%**.
- 4) **Growth from Inflation:** Over the last 77 years, growth from inflation was been **3%**.

Thus, starting where we are, assuming normal growth, and no change to the multiple (which is a generous assumption), that implies an expected return of 5.8% for stocks over the next decade.

Put another way, we're five years into the Secular Bear Market. Stocks have a *negative* rate of return of 5% per year since 2000. For us to achieve the normal 10% annual return from stocks for the 2000-2015 period, the S&P has to climb from its current level of 1202 (a/o 2/8/05) to a level of 6508. That

means achieving an 18% annual return between now and then. Assuming normal economic growth and inflation, and a constant dividend yield, that means the multiple (P/E) on the market must rise by 12% per year. That takes our current P/E (22) to a P/E of **68** (the market has never had a normal P/E of 35). The pressure is on the multiple to *fall*, not *rise*.

- 4) For stock dividend yields to return to their norm (4.5%) over the next decade, given normal growth of earnings, dividends, and inflation, the market must fall by 40%.**

	<u>2005</u>	<u>2015</u>
S&P 500 Level	1202	723
Current Dividend	\$ 22.00	\$ 32.56
Dividend Yield	1.8%	4.5%
<i>Change in Stock Market</i>		-40%
<i>Annualized Change</i>		-5.0%

- 5) Overall valuations today (P/E =22) look much like they have going *into* past Secular BEAR Markets.**

	<u>1895-1914</u>	<u>1914-1929</u>	<u>1929-1949</u>	<u>1949-1966</u>	<u>1966-1982</u>	<u>1982-2000</u>	<u>2000-??</u>
Cycle	Bear	Bull	Bear	Bull	Bear	Bull	Bear
Starting P/E	30	9	26	6	20	7	34
Ending P/E	9	26	6	20	7	34	22 (current)

- 6) The US bond market is also uniquely vulnerable.**

The best thing for bonds is an environment that sees interest rates falling and inflation falling. That's what we had from 1982 until 2003. The worst thing for bonds is an environment that sees interest rates rising and inflation rising. That's the likely environment going forward. Inflation has increased from an annual growth rate of 1% to 3.5% for the year just ended. Bond yields are coming off a *40-year* low and the 10-year Treasury bond yield is up by 33% (from 3% to 4%) since 2003. Every indication is that rates and inflation will continue to rise.

- 7) Real Estate has its own cross to bear.**

Record setting increases in US real estate prices have come at the cost of extraordinary increases in debt due to near-all-time-low mortgage rates. Not only are debt levels high, but the quality of lending is at a risky crossroads. We have: *record levels of sub-prime loans* (high rate loans to high risk borrowers), *record levels of non-conforming loans* (>80% loan-to-value) and the *highest percent of adjustable rate mortgages ever* (soon to be hit by rising rates).

- 8) This is a uniquely risky period, globally and domestically.**

Terrorism, Entitlement program insolvency, the aging of the "baby-boomers", the dependence on foreign investors for capital, the weakening dollar, China as an emerging power, the monetary bubble, and the return of heavy handed leadership in Eastern Europe are among the unique risks to our society in the decade ahead. No reason to be pessimistic—rather, a pragmatic approach to investing that recognizes how *the game has changed for the decade* and a recognition of the importance of financial self-dependence will ensure that people achieve their goals in this otherwise challenging decade.

10 WAYS THE GAME HAS CHANGED FOR THE DECADE AHEAD

- 1) **Buy-and-hold (stocks) no longer works.**
- 2) **Diversification is King (by asset class and geography).**
- 3) **Stocks: hold a lot--or a little--to outperform the market.**
- 4) **Absolute Return trumps Relative Return.**
- 5) **The CPI replaces the S&P 500 as the benchmark of choice.**
- 6) **The three most important letters of the decade: ETF.**
- 7) **Alternative Assets become the 3rd leg of the stool.**
- 8) **Floating rate notes trump traditional, fixed rate notes.**
- 9) **Seek yield wherever you can find it.**
- 10) **Minimizing Risk trumps Maximizing Return.**