Four Yards and a Cloud of Dust

> Wealth is considered to be the consequence of a life well lived...
> rather than the purpose of life itself.
>
> Rabbi Daniel Lapin, *Thou Shall Prosper*

During the roaring 1990's, Americans seemed to have forgotten the timeless lessons that Rabbi Daniel Lapin writes about in *Thou Shall Prosper, Ten Commandments for Making Money.* Over the last three years, Americans have lived through a terrorist attack on the nation, a recession, a war with Iraq, and a relentless, gut-wrenching bear market. Much easy money has been lost and not a little hard-earned money as well. In these times, the nation has been relearning the lesson that the creation of wealth is generally a long process – often a life-long process – and usually achieved by practicing the virtues of hard work, thrift, perseverance, saving, and prudent investment. As Rabbi Lapin says in the above quote, wealth creation is, in fact, the result of a life well lived. And when wealth is sought as a prime purpose, not as a consequence, it is usually elusive.

The life of billionaire Warren Buffet, the son of a Nebraska stockbroker and congressman, offers numerous examples of the value of thrift and frugality (what used to be known as husbandry) which Americans of all classes used to practice. As a youth, Buffet bought and fixed-up old pinball machines and then rented them out, making a tidy sum in the process. He also organized and paid his young friends to dive for golf balls in a water hazard at a nearby golf club, and then sold the golf balls to various clubs at a profit. According to Buffet's biographer, Roger Lowenstein, Buffet was already a multimillionaire when a travelling companion asked for a coin to make a quick call at an airport pay phone, when a dime was the going rate. Buffet fished a quarter from his pocket, but rather than hand the excessive coin to his friend, he walked a long corridor to find a shop that would make change.

Contrast this behavior to what is seen every day in a nearby fast food restaurant in Hartford. If a customer drops one or more coins – a penny, a nickel or even a dime, chances are that he or she will not even bother to bend down and pick up the coin. Even the employees of the restaurant – most earning less than $6.00 an hour – seem indifferent to the coins lying on the floor – as if too proud or too embarrassed to be seen bending over to pick up a penny. Perhaps, as a nation, we have become too affluent for piggy banks and the slow compounding of modest amounts of money.

Has the dream of winning the lottery ruined the concept of thrift? Or is it the dream of starting an Internet company and cashing out quickly with millions? Whatever the cause, the harsh realities of the new millennium are bringing back the virtues of hard work, saving, and careful investing for the long haul. In the vocabulary of football, it's back to "four yards and a cloud of dust." That is how the game of investing is going to be won in the foreseeable future – not the razzle-dazzle, behind-the-back lateral or the go-for-broke "Hail Mary" pass. Investment returns on stocks, bonds and money market funds have come back to earth.

Earnings Growth and P/E Expansion

The U.S. stock market had an exceptional run from 1982-1999 when quality growth stocks compounded at 17% annually. This produced a twelve fold increase in the Standard & Poor Index during these seventeen years. Lower taxes, de-regulation, and lower inflation produced a strong economy with robust corporate earnings. This was coupled with a significant expansion in the price/earnings multiple during this period as the table below shows. The combination of corporate earnings quadrupling in the period and the price/earnings ratio more than tripling produced one of the strongest and longest bull markets in the nation's history.

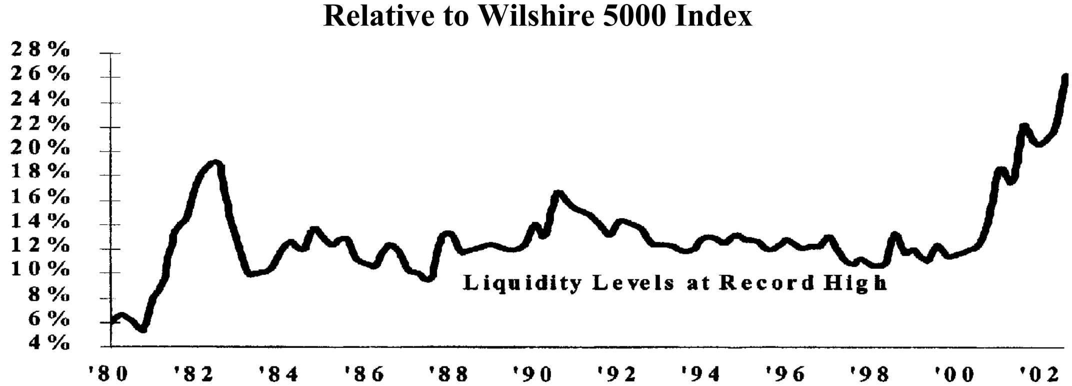
	S&P 500 Index Earnings	P/E Ratio	S&P 500 Index
1982	$12.64	8.7	110
1988	$23.75	11.7	278
1994	$30.60	15.0	459
2000	$50.00	28.0	1400
2003	$52.60*	16.9	890

* Estimated 2003 S&P 500 Operating Earnings

Investing in the New Environment

The stock market bubble burst in March 2000, and the ensuing bear market saw a decline from peak to trough of 50% for the S&P 500. The savage bear market, the recession, the terrorist attack on America, and accounting fraud has caused huge inflows into the asset class with the lowest risk: money market funds. After the Federal Reserve Bank cut interest rates twelve times, interest rates on money market funds range between .75–1.25% – the lowest rates in forty years. The chart below shows that money market funds as a percentage of the market value of the Wilshire Index is at the highest level in decades. Individuals are holding these levels of cash reserves in spite of a negative real rate of return.

Money Market Funds Assets
Relative to Wilshire 5000 Index

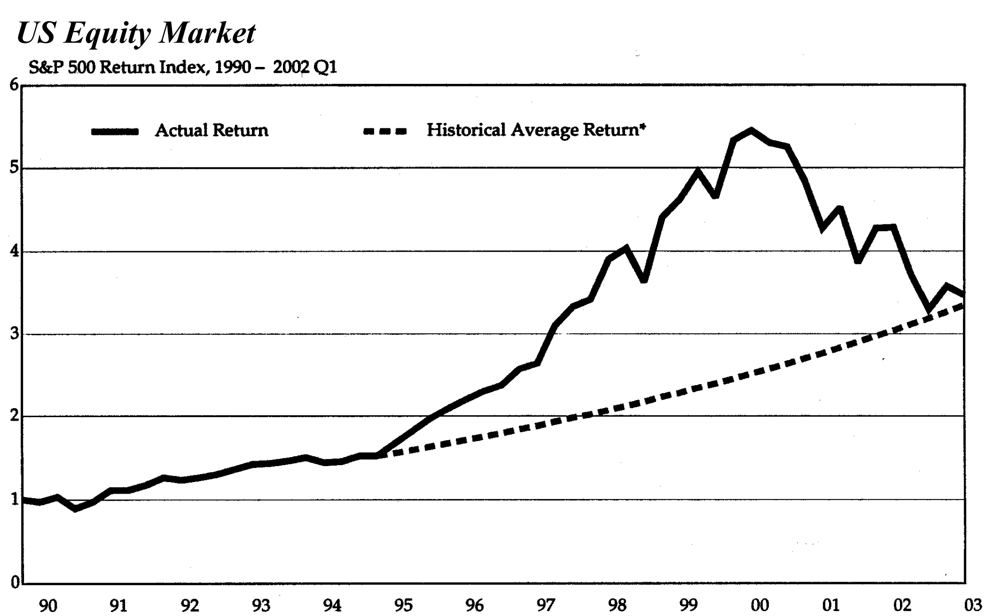


The Bond Bubble

The other asset class into which investors have poured funds is bonds – especially U.S. Treasuries. The combination of investors seeking a safe haven in difficult economic and geo-political times, low inflation and the Federal Reserve Bank cutting interest rates to provide stimulus for the economy has resulted in the lowest rates for U.S. Government bonds since the early 1960's. In March, the five year U.S. Treasury bond yielded 2.65%, while the ten year U.S. Treasury yielded 3.70%. Five to ten year investment grade corporate bonds such as Walmart or General Electric yielded a modest 4%. At the same time, inflation (as measured by the consumer price index) in March 2003 for the previous twelve months was 3%. Thus U.S. Treasuries provide very little, if any, real return on investment. This compares with the 2-3% real return that investors normally demand to invest in short and intermediate-term quality fixed income instruments. Many investors have forgotten the lessons of the past that even five to ten year bonds can also produce negative rates of return over a one or two year period. For example, a ten year U.S. Treasury bond, purchased today at a yield of 4%, will show a negative total return of 6.37%, if ten year interest rates rise to 5.5%. Clearly, widespread pessimism has caused many investors to practice W.C. Fields famous dictum: "I am more interested in return of capital than return on capital". In any event, an investor who buys a ten year bond yielding less than 4% (before tax) has expectations that are nearly as modest as the investor in money market funds.

Stocks: Reversion to the Mean

The average annual increase of the S&P 500 Index (including dividends) from 1926 through 2002 is 10.2%. For the period 1926-2000, the average annual increase was 10.7%, but the 30% drop in the last two calendar years brought the average annual increase down .5%. As the chart below shows, the U.S. equity market has returned to its normalized trend even for the last thirteen years.



* Assumes the 1960 – 1994 annualized return of S&P 500 of 10.0% Wellington Management

What is different in 2003, however, is the composition of the 10.2% average annual return. As the table below shows, the average annual contribution from price appreciation is only 6.1%. This intuitively makes sense, as the growth in corporate profits ultimately depends on the national economy (GDP growth has averaged 3%+ over the long-term) plus inflation (which has averaged 3%+ over the last sixty years). The contribution from dividends has averaged 4.3%. Currently the dividend yield on the S&P 500 Index is only 1.8%. *If the S&P 500 were to continue its historic average annual appreciation of 6.1%, then the S&P 500 total return at the current dividend level would total just 7.9%.* Even if President Bush wins approval for part or all of his proposed dividend tax cut and corporations respond by increasing dividend payouts, this would only increase the total return in the near-term to perhaps 8.5-9%. This, of course, assumes that there is little expansion of the market's price/earnings ratio over the foreseeable future.

Contributions of Dividends and Capital Appreciation to Total Returns
S&P 500 Returns 1926-2001*

	Total Return	Income Return	Capital Appreciation
1926-1939	5.1%	5.2%	-0.2%
1940's	9.2%	6.0%	-3.0%
1950's	19.4%	5.1%	13.6%
1960's	7.8%	3.3%	4.4%
1970's	5.9%	4.2%	1.6%
1980's	17.5%	4.4%	12.6%
1990's	15.9%	1.7%	14.0%
1926-01	10.7%	4.3%	6.1%

* S&P 500, Ibbotson Associates, Inc.

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This brings us back to the theme at the beginning of our investment commentary. It is unlikely that investors over the foreseeable future will see mid-teen stock market returns similar to those of the 1950's, the 1980's and the 1990's. Returns in the mid-to-high single digits are much more likely over the next few years. Nonetheless, with core inflation of only 2% currently, these returns will produce average real rates of return of 7.0%. This is the stock market mean over the past two centuries, according to Jeremy Siegel, author of *Stocks for the Long Haul*. While average annual real rates of 7% may seem modest, it is important to remember that $1 turns into almost $16 in forty years and $180 in seventy-five years at this modest rate or return. However, if investors are persuaded by pessimistic economic or political prospects to hold their money solely in money market funds and intermediate and long-term bonds, the chance to achieve these sorts of returns are currently ruled out. Investors should periodically review their investment objectives to ensure that their assets are allocated according to their risk/reward tolerance, time horizon of the investment, tax status, and income needs. There is plenty of money to be made long-term through prudent investment in a diversified portfolio of growth stocks.