



# Bradley, Foster & Sargent, Inc.

## Quarterly Market Commentary

July 2005

### Taking the Long View

“He who wishes to grow rich in a year will be hanged in six months.”

Dr. Stephen Maturin in *The Letter of Marque*, Patrick O'Brian

In the Spring of 1999, the Dow Jones Industrial Average, after flirting with the 10,000 mark for some weeks, finally crossed that threshold. In early 2000, it rose to a high of 11,750 before succumbing to the great 2000-2002 bear market. Now, more than six years after this index first crossed the 10,000 barrier, the Dow Jones is still trading at this same level. On April 18, 2005, the Dow Jones traded briefly intra-day below 10,000 before commencing its most recent rally, which has brought it back to 10,520. The broader S&P 500 Index, which has a heavier technology weighting than the Dow Jones, recently traded near its four-year high of 1229, but it is still more than 20% below where it traded in March 2000. Furthermore, even over the short run as measured by the first six months of 2005, investors didn't have much to be pleased about. The S&P 500 was down .80% for the first half year; the Dow Jones & NASDAQ Composite performed even worse, declining 3.65% and 5.45% respectively.

So, how long must investors wait until they see the Dow or the S&P 500 attain new all-time highs? Will it last as long as the sixteen years from 1966 and 1982? Perhaps, stock market investors, having so enjoyed the roaring 1990's, must now suffer a long period of despair not unlike Sisyphus, who was condemned to push the rock back up the mountain each time after it fell. In times like this, the importance of patience for stock market investors cannot be overemphasized. So, before turning to examine the reasons why the stock market is having difficulty making headway this year in spite of the good U.S. economy, it is useful to examine what Professor Jeremy J. Siegel wrote in his recent book, *The Future for Investors*.

### Tried and True Stocks Outperform

In *The Future for Investors*, Siegel investigated which kinds of stocks performed best over the long term. He focused on stocks in the 1950's and followed them for a 45-50 year period. His conclusions can be summarized as follows:

- From March 1, 1957 through December 31, 2003, the S&P 500 Index provided a total return of 10.85% per year. A \$1,000 investment in the S&P 500 in 1957, with dividends reinvested, resulted in \$124,522 at the end of 2003.
- The more than 900 new firms added to the S&P 500 Index since it was formulated in 1957 have, on average, underperformed the original 500 firms in the index.
- Long-term investors would have made more money if they had bought the original S&P 500 firms in 1957 and never bought any of the ones added to the index –

assuming that investors held onto the spin-offs and/or the acquiring firms. This strategy produced a compound annual return of 11.40% – \$157,029.

- Dividends matter a great deal. Reinvesting dividends is the critical factor that provides the edge to most winning stocks over the long run. Portfolios invested in the highest-yielding stocks returned 3% per year more than the S&P 500 Index while those in the lowest-yielding stocks lagged the market by almost 2% per year.
- Finally, the return on stocks depends not so much on the earnings growth of a company but on whether the earnings growth exceeds what investors expect. In other words, high expectations as exemplified in high P/E ratios tend to cause stocks to underperform over the long run. As an example, railroad stocks, despite shrinking from a 21% weighting in the S&P 500 Index to less than 5% during this 46-year period, outperformed the index over this period.

### IBM vs Standard Oil of New Jersey (Exxon)

An example which Siegel uses to good effect is a comparison between two great U.S. companies – one, the dominant technology company for this period and the other, a great “old economy” energy company. As can be seen below, both companies had terrific performance due to their excellent business models, but Exxon slightly outperformed IBM, as its higher dividend yield more than compensated for its slower earnings growth.

	<u>IBM</u>	<u>Standard Oil/ Exxon</u>	<u>Advantage</u>
<b>Annual Growth Rates 1950-2003</b>			
Revenue per Share	12.19%	8.04%	IBM
Dividends per Share	9.19%	7.11%	IBM
Earnings per Share	10.94%	7.47%	IBM
<b>Average Valuation Measures 1950-2003</b>			
Average P/E	26.76	12.97	Exxon
Average Dividend Yield	2.18%	5.19%	Exxon
<b>Measures of Return 1950-2003</b>			
Price Appreciation	11.41%	8.77%	IBM
Dividend Return	2.18%	5.19%	Exxon
<b>Total Return*</b>	<b>13.83%</b>	<b>14.42%</b>	<b>Exxon</b>

\* Assuming all dividends are reinvested

Siegel lays out for his readers a number of key “lessons learned” from his study of the stocks which performed best – if held throughout the second half of the 20th century. One of his main conclusions is that companies with strong brand names in the consumer and pharmaceutical sectors have tended to provide superior returns. Warren Buffett prefers to say: “The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.” Another critical concept is that stockholder returns are driven by the difference between actual and expected earnings growth, and where actual earnings growth exceeds the expectations (P/E ratio), substantial rewards are available to investors. Another is that dividends matter a lot over the long term. Finally, none of the winners below had an average P/E ratio over 27 (according to Siegel’s work, the stock market’s average P/E over the past 45 years has been 17).

## Top Twenty Performing Survivors of the 1957 S&P 500 Index

Rank	2003 Name	Accumulation of \$1000	Annual Return	Rank	2003 Name	Accumulation of \$1000	Annual Return
1	Philip Morris	\$4,626,402	19.75%	12	Wrigley	\$603,877	14.65%
2	Abbott Labs	\$1,281,335	16.51%	13	Fortune Brands	\$580,025	14.55%
3	Bristol-Myers Squibb	\$1,209,445	16.36%	14	Kroger	\$546,793	14.41%
4	Tootsie Roll Industries	\$1,090,955	16.11%	15	Schering-Plough	\$537,050	14.36%
5	Pfizer	\$1,054,823	16.03%	16	Procter & Gamble	\$513,752	14.26%
6	Coca-Cola	\$1,051,646	16.02%	17	Hershey Foods	\$507,001	14.22%
7	Merck	\$1,003,410	15.90%	18	Wyeth	\$461,186	13.99%
8	PepsiCo	\$866,068	15.54%	19	Royal Dutch Petroleum	\$398,837	13.64%
9	Colgate-Palmolive	\$761,163	15.22%	20	General Mills	\$388,425	13.58%
10	Crane	\$736,796	15.14%		<b>S&amp;P 500</b>	<b>\$124,486</b>	<b>10.85%</b>
11	H.J. Heinz	\$635,988	14.78%				

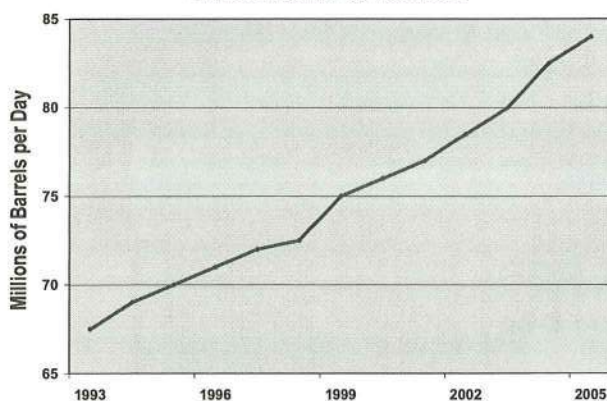
Source: Jeremy J. Siegel, *The Future for Investors*

The above table shows that the top twenty performing survivors of the 1957 S&P 500 Index handily outperformed the S&P 500 Index. Importantly, many companies that have come public over the past twenty or thirty years have shown exceptional compound annual returns as well. These include technology companies such as Intel, Microsoft, Dell, and Cisco; retailers such as Wal-Mart, Home Depot, and Limited Stores; and distribution companies such as Sysco. Each of these companies has had average annual returns of 20% for one or more decades, and while not always exhibiting the characteristics that Siegel identifies, they are firms with wide moats and very strong earnings growth. As the aggregate performance of the top twenty survivors has not been so robust in recent periods, our focus remains on identifying the next set of winners.

### The Near Term View

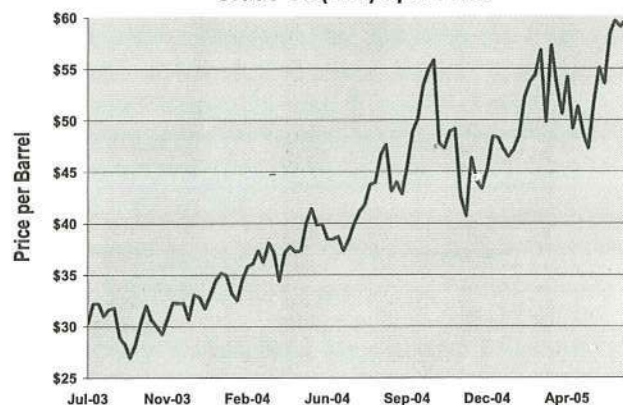
For those people whose investing horizon is shorter than fifty years or even a single decade, two questions come to mind: "Why is the market acting poorly thus far in 2005?" And "Where is the market headed for the remainder of this year?" As we have written so many times before, we do not pretend to be able to predict the path of the stock market. However, we have some theories about its poor performance so far this year. We also believe that there are reasonable grounds for optimism for the remainder of the year. The charts below tell most of the story about the market's poor performance thus far in 2005:

**Annual World Oil Demand**

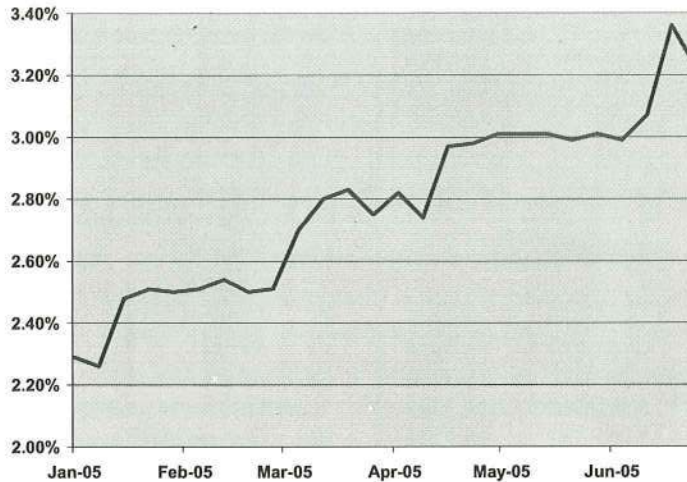


Source: International Energy Agency

**Crude Oil (WTI) Spot Price**



**January – July 2005  
Federal Funds Rate**



Despite the drag of significantly higher energy prices and increasing short-term interest rates, the U.S. economy has continued to perform well. GDP growth has surprised economists by remaining at 3.5%+, and the unemployment rate has fallen to 5%. The budget deficit will likely be \$100 billion less than projected a year ago, and as a percentage of GDP, it will probably come in at around 2.8%. The U.S. dollar has strengthened significantly since year-end. The war in Iraq continues to be worrisome, but the Iraqis seem to be making progress in training their own military and in crafting a constitution. Finally, China and India continue to evidence rapid economic growth and provide other engines for global economic growth.

All in all, we believe that the stock market has held up well in the face of the Federal Reserve's tightening and the rise in energy prices. Investors in the bond market seem to be betting on an economic slowdown in the U.S., as U.S. interest rates on intermediate and long-term bonds have remained low. But corporate earnings continue to be robust, and we still believe that if the S&P 500 Index were at 1275 by year-end, it would not be overvalued (16.3 x 2006 S&P 500 estimated operating earnings of \$78) – in an environment with inflation at 3% or less. We think that the market will make its move when the Federal Reserve stops raising rates. And we think that the Fed will stop, or at least take a long pause, by this Fall.

While no one can be sure what the next six months will bring for investors, the “long view” of equities in the U.S. is very encouraging. While it is clear that not all stocks will perform well over the long term, nor even the majority of stocks, the evidence is strong that an actively managed, diversified portfolio of quality growth stocks (most of which have a “moat” and pay a rising stream of dividends) is likely to produce a superior inflation-adjusted rate of return over the long term. And at Bradley, Foster & Sargent, Inc., we are committed to taking the long view of building wealth for our clients by executing this investment philosophy and approach.

**Bradley, Foster & Sargent, Inc.**

*Investment Management*

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