

The Long-Term Case for U.S. Equities

by

Chris Grisanti

Grisanti Brown & Partners LLC

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Equities stink. They are as discredited now as at any time since 1975 or even 1938. And why shouldn't they be? As you can see from the chart within, the S&P 500 Index just delivered its worst ten-year compound return *ever*. Worse than the ten years that ended in the market bottom in 1975, worse even than any ten year period during the Great Depression. When an asset class has treated you that badly, why would anyone want to buy a stock?

What follows is a defense of a forlorn asset class that has been discredited, beaten up and left for dead. U.S. equities, like any other asset class, are neither inherently good nor bad, but should be judged in the context of the long term economic outlook and their current valuations. When viewed through this long-term lens, U.S. equities present a very compelling return potential over the next three to five years. First, there is incredible negative sentiment surrounding common stocks. The very fact that this essay is even of interest -- the case for equities would have been self-evident to many in the go-go years of the late 1990s -- emphasizes the pessimism surrounding an inherently cyclical asset class. To contrarians, this at the very least arouses interest. Second, valuations based not on 2009's disastrous earnings outlook but on long term earnings power are extremely low. Industries that have slowed sharply, but are not over-dependent on the use of leverage can experience strong earnings growth as the economy recovers. Many stocks do not currently reflect this. Finally, as frequently as comparisons to the Great Depression are tossed about, to paraphrase Lloyd Bentsen, we know the Great Depression, we've studied the Great Depression, and this is no Great Depression. As discussed in detail below, while both periods present similar *type* problems, even the most pessimistic forecasters do not contemplate anywhere near the same *magnitude* of the issues experienced during the Depression. In addition, the fiscal and monetary responses today are both more timely and much larger than in the 1930s. Unlike that miserable period, once the credit markets return, the long term productive capacity of the United States can recover over the next three to five years.

This essay will discuss each of these factors, but first the disclaimers: This is not a call that stocks have necessarily "bottomed", nor is it a plug for short-term gains in the current rally now under way. Markets bottom unpredictably; rallies can end quickly and with great disappointment. Instead, the proposition is that three to five years from now, you will have made above-average returns in U.S. equities from today's prices. Where those prices go over the next several months is anyone's guess. This is also not simply a forecast based on the sentiment from the old Nancy Sinatra song "I've Been Down So Long It Looks Like Up to Me." Just because assets decline doesn't necessarily mean

they rise again, as the shareholders of Washington Mutual, General Motors, AIG and many other companies will attest. Rather, the case for long-term equities relies on the three prongs of pessimism, valuation and American productive capacity.

Pessimism: The Painful Backdrop of Value

There are a lot of reasons to be pessimistic right now. To pick among the finalists, the still horrible state of our banks and the ever-declining value for our nation's housing stock would have to be near the top of anyone's list. Yet pessimism without analysis is as unhelpful an investment lens as boundless optimism. Quantitative questions need to be examined. How horrible is the state of our banks? Are they all in the same situation, or will some survive? Does the fact that the equity valuations of Lehman Brothers, Bear Stearns, AIG, Fannie Mae, Freddie Mac, Citigroup, Washington Mutual (the list goes on) have virtually all disappeared count for something? Enough? On the housing front, is the value really "ever-declining"? In other words, will there be a time in the not-too-distant future when, with 4.5% mortgage rates, housing prices will start to stabilize? Yes, the economy is bad, but the second part of the investment decision is always whether price -- in whatever asset class is being examined -- reflects the current circumstances *and* those that will exist in the future.

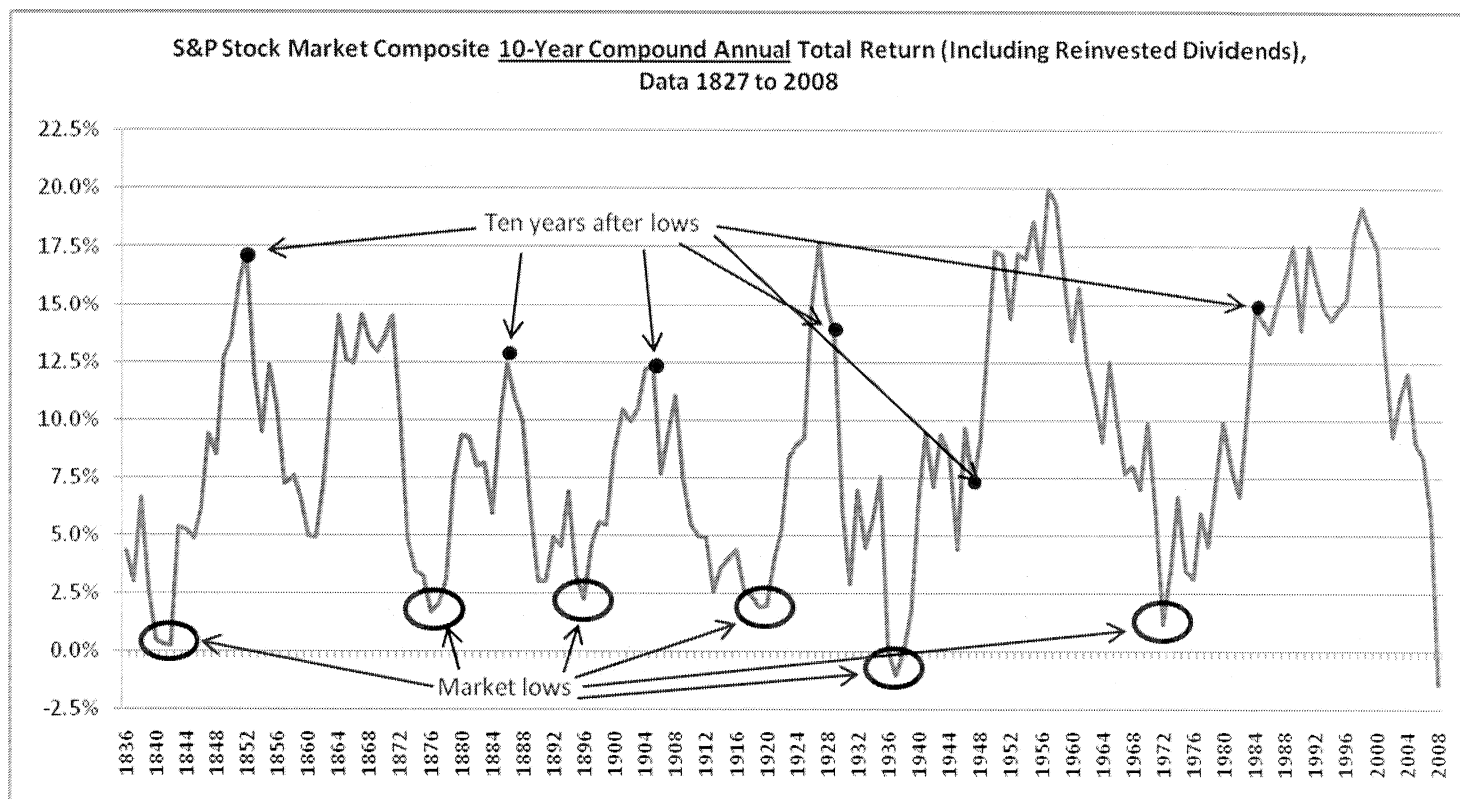
The answers to the questions in the previous paragraph are not all happy ones. For example, a number of banks truly are in a horrible situation. Further, reasonable professionals can -- and do -- disagree about the current state of affairs. But, one question that also needs to be asked is: Why do the most strident arguments *against* owning stocks appear *after* stocks have suffered a 55% decline and have offered investors their worst ten-year return ever? The thoughtful and respected Bill Gross from PIMCO (not coincidentally, a bond manager), lists equities in his April 2009 Investment Outlook among assets that will fair poorly *going forward*: "Investors should therefore favor stable income as opposed to speculative growth or the subordinate liability structures [i.e., equity securities]." His advice remains "Shake hands with the government" for the best, safest fixed income returns.

In a similar vein, he and many others point out a shocking, *shocking* fact that U.S. Treasury bonds, after hitting record low yields (and thus record high prices) have outperformed stocks (now hitting near-record low prices) over the last 25 years. Thus, they conclude, it's foolish to own stocks and an investor -- even one with a long time horizon -- ought to "favor stable income" over equity ownership. But if financial history has taught us anything, it is that asset classes have their cycles. It's not hard to imagine, with investors in February having to pay for the privilege of loaning the government money (negative t-bill rates), that we're near the top of the U.S. Treasury bond cycle. Whether we are seeing the bottom of the equity market is anyone's guess, but which asset class would you want to own for the *next* ten years, the one at its peak or the one at its low?

The following 182-year chart speaks volumes as to the long-term cyclical nature of the U.S. equity market. It shows the 10-year compound annual return of the S&P 500 Index (and its predecessors), and for almost the entire 182 years the 10-year return

remains in positive territory. In other words, if you had bought stocks, in good times or bad, ten years later you would at least have had a positive return, sometimes anemic, sometimes quite lucrative. There are, however, some rare, unfortunate points at which, even over a ten-year stretch, your returns would be almost zero or even negative. As might be expected, the end of the Great Depression (1938) is one such point.

Significantly, at the end of 2008, the 10-year return goes negative again, this time by an even wider margin. If you had invested in the S&P 500 Index in 1998, you would have lost, on average, more than 2% annually over the last ten years.¹



Source: "A New Historical Database for the NYSE 1815 to 1925: Performance and Predictability" William N. Goetzmann, Roger G. Ibbotson, Liang Peng, Yale School of Management; 1925-to-present is Standard & Poor's data.

Negative readings produce extreme pessimism with regards to the future of equities. Not surprisingly, in the late 1930s and the mid-1970s, stocks were held in disdain as an asset class. Today those sentiments are echoed by smart people like Mr. Gross. The chart is not helpful in predicting exactly when the low will occur, or at what price, but we find the current record low reading a very persuasive pictorial argument in favor of the long-term case for equities. We have also indicated the points that occurred *ten years after the major lows* since 1832. Each of these points shows that investing at these lows produced *above average returns* in the following decade. One of the best

¹ Clients of Grisanti Brown & Partners fared much better, making 24.8% after fees from the end of 1998 to the end of 2008, because they owned different stocks than the S&P 500.

times to buy an equity interest in a well-managed corporation is when it has underperformed for the previous ten years. Emotionally, it's also the hardest time to buy.

In his quintessential way, Woody Allen once described the type of pessimism that seems to pervade the equity markets today: "*More than at any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly.*" With such grim expectations, any piece of good news -- including merely a lessening in the rate of decline of employment or manufacturing -- would be seen as unexpected and would be quite welcome by the equity markets.

Valuations: Forget about 2009

There are three kinds of lies: lies, damned lies, and statistics, said either Mark Twain or Benjamin Disraeli more than a century ago. We bet that neither one was at that moment debating the correct P/E multiple for the market bottom, but the phrase is apt. On one side are the bulls, who calculate that with low interest rates and economic recovery coming quickly, a high multiple is justified, and so the market is currently *undervalued*. The bears argue that earnings estimates are falling faster than share prices. They estimate the market is still *overvalued*, even though it's already down so much. But anyone who has ever tried to buy or run a business knows that figuring what the proper multiple of severely depressed earnings should be is not asking the right question. Long term investors want to know about the cash flow *potential* of the businesses they are buying, and the disastrous earnings of 2009 are not a fair benchmark to use for pricing either an entire business or a publicly-traded share of one. While no one knows when GDP will stop declining (we expect the first quarter of 2010), we are confident it will resume growth within our three-to-five year investment horizon. Those companies that relied on the availability of leverage to grow, like banks, car makers and homebuilders, will have a tougher time rebounding. But there are plenty of other sectors, like technology, entertainment or health care, that should be able to grow their earnings back to and beyond levels seen in 2007 *over time*. If that's the case, then the stocks of companies like Cisco, Microsoft, Pfizer or Time Warner are so oversold that they can appreciate by 50-100% and still remain at normal valuation levels as earnings growth resumes. Again, this is *not* a short term call for a stock market or earnings rebound. Instead, it's just making the case that things will not always be this bad. When earnings growth does return -- and the return does not have to be heroic -- many stocks in numerous sectors will prove to have been extremely cheap.

The Worst Cliché Since the Great Depression

Every commentator, including those at our firm, has been guilty of describing aspects of these times as the worst decline/greatest loss/longest slump "since the Great Depression." As a factual matter, that may be true. But it leaves the impression that these times are very similar to those times. So far, they are similar in *what* is happening -- a banking crisis, a sharp stock market decline, job losses and a real estate implosion -- but they are very different in the *magnitude* of the effect on the U.S. economy. Taking

the most pessimistic assumptions, GDP will be down about 7% from its high in the two years between the Fall of 2007 and the Fall of 2009. In the two years from the peak in 1929 to 1931, *GDP was down 26.1%*. Unemployment is now rising towards 8.5%. It could approach 12%, though the most pessimistic forecasters are still shy of that figure. It's true: that would be the worst unemployment rate "since the Great Depression", but it's nothing approaching the 35% unemployment of 1933.

The view that this is not your grandfather's depression is also rooted in the vast differences in governmental response. This is true globally, but most importantly here in the U.S. The depth and breadth of the controversial liquidity programs have been unprecedented. By current count, there has been over \$1.8 trillion of new spending or investment in the United States alone, and there is promise of more on the horizon. Recalling the 1930's, aside from some monetary easing, the Hoover administration enacted few policies to address the economic slump. In fact, the highest marginal tax rate more than doubled in 1932, the beginning of the worst two years for the economy. It wasn't until FDR began laying the groundwork for the New Deal in 1933, nearly four years into the slump, that policy actions grew aggressive enough to reverse the course. So, not only is the magnitude different, but the level and urgency of intervention today appears to be an important difference that could yield more favorable results.

The real differences between the Great Depression, and the terrible recession we're going through now -- and the mistaken investment thesis that they are very similar -- leads us to our final reason to be bullish on U.S. equities long-term: The productive capacity of the United States has been neither destroyed nor nearly as badly damaged as it was in the 1930s. It has suffered a severe shock brought about first by over-leveraging and then by the overnight evaporation of credit. The damage was widespread, and it will take a while to recover. But in a world where credit is available again on reasonable terms, companies can start to grow again. For each of the 22 companies currently in our portfolio, we believe that earnings can return to 2007 levels on or before 2012, even in a pessimistic scenario. For some of them in the health care and insurance industries, earnings should grow above 2007 levels as soon as 2010.

Apart from the markets, apart from the commentators, well-capitalized business still make computers, movies, drugs, furniture and software. They also provide services like accounting, health care, transportation and legal advice. After a terrible 2009, we believe those companies will begin to feel renewed demand for their offerings. After a truly horrible two and a half years, we think improvement will begin in 2010. To think things will be even worse than that would be the most bearish sentiment since the Great Depression.

Pay Attention to Stock Selection

After an indiscriminate decline in the fourth quarter of 2008, the equity market has again begun to separate the wheat from the chaff. Correct stock selection has always been crucial over the long term, even among stocks within the same business. Even now, as the financials have suffered terribly, the market clearly prefers JP Morgan and Goldman Sachs to Citibank and Bank of America. The former are up sharply in 2009,

while at the same time the latter have lost more than half their value. The assertion that equities will offer above average returns over the next ten years is not the same as saying they will soar from here. We could well be in for a decade like the 1970s, in which individual stock selection offered much of the return to investors rather than a 1990s-like rising tide lifting all ships.

Whether it is Grisanti Brown & Partners, or some other firm that spends its time analyzing balance sheets and talking with managements, find someone who does their homework. Stock picking matters. Each investment listed on your brokerage statement is a real company that offers certain goods or services, employs a specific workforce and relies on its own sources of capital. All of those factors need to be understood to optimize your return. A good investment advisor undertakes that analysis and then sorts through the *prices* offered for those businesses, evaluating whether the potential return is worth the current risk. At the end of the day, a 'U.S. equity security' is just a fancy name for owning a piece of an American business. The current wisdom -- that an equity interest in the profits of an American business is, in perpetuity, a poor investment -- is not merely short-sighted, but ignores what could be a tremendous opportunity.

We welcome any comments and questions you may have about this piece. They can be directed to Chris Grisanti at Grisanti Brown & Partners LLC (212) 218-5302 or cgrisanti@grisanitibrown.com.