

# The Portfolio Reporter

A Newsletter Provided by Dunn Warren Investment Advisors

May, 2006

This month I am going to reference a letter to the editor that I wrote to *BusinessWeek* (BW). My letter was published in the May 8<sup>th</sup> edition (“The Best Undergraduate Business Schools” is the cover story), on the “Readers Report” page 18 ([http://www.businessweek.com/magazine/content/06\\_19/c3983015.htm](http://www.businessweek.com/magazine/content/06_19/c3983015.htm)).

I wrote this letter in response to the cover story “Blue Chip Blues - How long will the stocks of America's largest companies remain weaklings on Wall Street?” in the April 17, 2006 edition ([http://www.businessweek.com/magazine/content/06\\_16/b3980001.htm](http://www.businessweek.com/magazine/content/06_16/b3980001.htm)). The BW article states that there is a “disconnect” between earnings growth and stock prices. It points out that, while companies such as Home Depot and Intel have seen earnings increase 100% and 173% respectively, the stock prices of the largest 100 companies have increased only 2.03% annually during the same time. Consequently, the authors suggest “The blue chips [Large company stocks] will see another bull market, and perhaps soon.”

Hogwash!

Here is my response:

**Quoting earnings growth from the depressed period of 2001 to the present overemphasizes the growth that the companies quoted in your article have experienced. It is more appropriate to take a longer period or measure earnings growth from peak to peak or trough to trough, whereby investors can determine sustainable future earnings growth. When measured this way, earnings for the companies in the Standard & Poor's 500-stock index as a whole, going back to 1938, have grown 6% annually. Earnings reached 35 times forward earnings projections in 2000. Yet, stock performance lags for years once price-earnings multiples peak. Research conducted by Crestmont Research indicates that after strong periods of p-e multiple appreciation, such as we had from 1982 to 2000, multiples contract. In fact, cyclical bear markets start with a p-e multiple well above 20 times and end the slide in the single digits (1901-20, 1929-32, 1937-41, 1966-81).**

Exchange Traded Fund Market Performance - As of Apr. 30, 2006		
	1 Month % change	12 Month % change
S&P 500	1.3	13.5
S&P 500 Growth	-0.1	9.2
S&P 500 Value	2.8	18.1
S&P 400 Mid-Cap Growth	0.6	25.8
S&P 400 Mid-Cap Value	2.1	27.7
S&P 600 Small-Cap Growth	-0.2	30.1
S&P 600 Small-Cap Value	0.1	30.1

**Earnings multiples in the mid- to high teens for the blue chip shares would therefore drop further from here if history proves correct.**

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In case the research in my letter does not clearly indicate it, allow me to assure you, I have no intent, at the moment, of investing in large U.S. companies as the original article in *BusinessWeek* suggests.

As always, our goal is to assess the current economic environment, find those investments with reasonable valuations, and select those investments experiencing relative strength. As long as current economic conditions persist, we will remain invested in Japan, precious metals, and telecom. For those wanting a touch of the United States, we will invest in those small-cap companies that have reasonable valuations.

*All numerical data has been provided by Barclays Global Investors, unless indicated otherwise.*

*Please feel free to pass the “Portfolio Reporter” to interested friends and family members.*

*The opinions expressed here are based on the author's views and should not be construed as financial advice. For more information about your investments, please contact your financial professional.*