

The Portfolio Reporter

A Newsletter Provided by Dunn Warren Investment Advisors

September, 2006

The market is composed of opinions. This is what makes the stock market go around. Buyers compete with sellers to set the price of the market and individual stock prices each day.

The current argument for buyers is twofold: valuations are low and the economy is growing. I will explore the first item this month and the second item in October.

When investors say the stock market has low valuations, they substantiate that using the FED model. This is a term applied to comparing the earnings yield of the stock market to the yield of the ten-year government bond. Alan Greenspan popularized this in the 1990s. The model works as follows:

Take all the earnings of the 500 companies in the S&P 500 (an unmanaged index representing the 500 largest companies in the U.S.). Divide this number by the price of the S&P 500. Compare this rate to the interest rate of the risk free 10-year government bond. (It is called "risk free" because the U.S. government doesn't default; it simply raises taxes to pay interest on the bonds.)

Now let's use this model for August 31, 2006. Go to www.standardandpoors.com and get the reported earnings for the S&P 500 \$74.64. Then go to your favorite financial site (we use Yahoo financial), and get the price of the S&P 500 1,303.82. While you are on that site, get the yield of the 10-year government bond. Divide the earnings of the S&P 500 by the price, and you get 5.7%. Compare this to the government bond interest rate of 4.7%. The yield from the stock market S&P 500 is higher. Therefore, we should choose the investment with the highest yield, just as when searching for a bank to open a savings account, we search for the bank with the highest interest rate. Right?

Wrong!

Here is why: Comparing the government bond interest rate with the earnings yield of the S&P 500 is not a fair, apples-to-apples comparison.

1. The bond index is risk free, while the market, as we learned in May, can lose money.
2. The bond has a life of 10 years; the stock market is infinitely longer.
3. The FED model has worked since 1980, say supporters. This is absolutely correct and *quod erat demonstrandum* the stock market is undervalued . . .

However, both bonds and stocks performed like champs from 1982 until 2000 due to receding inflation. Coincidentally, the government was paying down debt, international competition was lowering prices, and oil prices receded with the end of the Middle East oil embargo. Previous to 1980, however, the correlation becomes weaker.

If we compare the reported earnings of the S&P 500, \$74.64, and divide that by the price, 1,303.82, we get 17.5. At 17.5 times earnings, the price of the S&P 500 falls at the high end of the range of prices from 1871. Historically valuations have ranged between 8 to 20 times earnings. In other words, investors will pay \$17 today to receive a stream of earnings in the future. If you think earnings will increase in the future, it would take less than 17 years to recoup the cost of your investment. While we *could* see the multiple go from 17 times to 20 times, it would require a stronger economy. Stay tuned, and next month we will address economic growth.

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.