



## PLIMSOLL MARK CAPITAL

### Don't Ignore Equities

The S&P 500 last achieved a meaningful new high in the year 2000, at the end of the dot com bubble. Today, eleven years later, the S&P Index remains more than 25% below that peak as our economic and financial woes continue. Will our economy slip back into recession? Will the Euro break down along with the European banking system? Is the Chinese economy in its own bubble? Is our political process still functional?

While we cannot chart the path through the world's economic and financial troubles, we would suggest that these issues are well known and at least partially discounted in the financial markets. However, that observation provides scant comfort for investors who are rightfully concerned with the market's volatility and dramatic response to every new development. Rather, the case for equities must be built on a solid foundation of three fundamentals: **valuation, dividend yield, and growth.**

Looking first at measures of **valuation**, the S&P 500 Index, at 1,130, trades at 13.5 times current reported earnings, or an even lower 12.5 times operating earnings (before special charges). Compared to a longer term average of about 15 times, the market appears reasonably undervalued even without giving any credit to higher earnings over the next twelve months.

However, there is an alternative valuation tool that is even more interesting, and it is based on the stock market's earnings yield. Earnings yield is calculated by dividing earnings per share by the share price (reciprocal of the p-e ratio), just as a bond yield is the coupon payment divided by the bond price. The current 8.0 % earnings yield on operating earnings of the S&P 500 Index compares to the ten year Treasury bond yield of 1.8 %. The difference is the earnings yield spread, in this case a positive 6.2%.

Note in the following chart that the earnings yield spread has been widening over the past decade



with bond yields declining and the S&P's earnings yield rising. The current 6.2% positive spread compares very favorably to a long-term range of roughly negative 2% to positive 8%. It has been a long time since stocks appeared this cheap relative to the ten year Treasury bond.

Turning to **dividend yield**, the S&P 500 Index currently yields 2.3%, while many

high quality global franchise companies yield 3% or more. As you can see on the following chart, we have to go back to the mid 1950's to find the last time when the S&P 500 yielded more than ten year Treasury bonds and that marked the beginning of the great post war bull market. Question: would you rather own a long-term Treasury bond yielding 1.8% or a high quality global franchise stock yielding 3.0%?



Source: Bloomberg, US Treasury, S&P 500

Looking finally at **growth**, purchasing power growth is the investment challenge of our era, especially considering the “financial repression” outlook discussed in a previous Plimsoll Perspective. Achieving a “real” return over the longer term, that is a positive rate of return greater than inflation, will depend on a combination of income and growth: assured current income supported by longer term earnings and dividend growth. Investors must not lose sight of the growth component, for that is the only way to stay ahead of inflation, and only equities have historically filled that role.<sup>1</sup>

We would be remiss if we did not mention the counter argument to the “equities are cheap” story – that is equities would not appear so cheap when interest rates ultimately rise and the yield spread narrows. While that may be true, in the process nominal earnings and dividends would be quite strong while bond prices would be quite weak, so equities would remain the relatively superior investment.

We recognize that the stock market could remain in a broad, volatile trading range for quite some time. Moreover, we do not know when the market will begin tracking the 6.4% “real” return path that the Plimsoll Global Investment Committee expects for global franchise equities from current levels. But we do believe that the stock market currently offers superior long-term returns based on the three powerful elements: (1) valuation; (2) dividend yield; and, (3) growth. In our view, patience will be rewarded by owning a portfolio of carefully selected dividend paying global franchise stocks.

<sup>1</sup> Past performance is no guarantee of future results.