

MEMBERS™ CAPITAL ADVISORS

COMMON STOCKS TODAY: A GOOD LONG TERM VALUE

March 2009

My report for this month provides a framework for investors regarding the current equity market. My analysis focuses on two specific areas pertaining to common stocks: (1) Long-term historical patterns of rates of return in the equity market; and (2) Current equity market valuation. Many investors are focused on market timing and predicting the market bottom, which is a losing strategy. Because of the difficulty in predicting the unfolding of economic events over the next year, investors should place greater reliance on two known factors: current long-term valuations and long-term historical patterns of equity market behavior.

Three Basic Principles - Although equity market valuations are extremely depressed and appear to offer good value within a long-term context, there are valid reasons why stocks are depressed, given the heightened level of economic and financial risk. While the economic outlook offers little cause for optimism at the moment, there are three important basic principles that should be emphasized. The first is that stocks are a leading indicator and will likely reverse course and begin a sustained market advance well before the economy embarks on a sustained recovery path. Secondly, all measures of valuation indicate that the equity market is significantly undervalued at current prices. Finally, a study of history reveals that the equity market tends to follow a fairly consistent and systematic pattern of prolonged periods (10-year holding periods) that alternate between above-average and below-average rates of return.

Historic Returns - Professor Jeremy Siegel of the Wharton School has compiled historic returns on common stocks using rolling time periods of 5, 10, 20, and 30 years, beginning in 1871. These returns were updated through

2008 in the March 7 issue of Barron's, with the assistance of WisdomTree Asset Management. There are numerous important conclusions associated with this historical data. The most general is that there is not a single 20-year period since 1871 during which the compound annual total rate of return on common stocks was negative, after adjustment for inflation. There were 118 such periods and each registered positive real rates of return, with the median rolling 20-year period showing a real compound annual return of 6.85%.

Shorter-Term Horizons - The data is also very encouraging regarding shorter-term time horizons, albeit not quite as unambiguously positive as the conclusions pertaining to the 20-year periods. More specifically, for rolling 10-year intervals, common stocks produced positive inflation-adjusted returns 90% of the time; for all holding periods of 5 years, positive real rates of return were achieved in 82% of the timeframes. In the current environment, of greater relevance are the findings regarding expected returns from common stocks following long periods of dismal performance. The key message of history is that prolonged periods of poor equity market performance tend to be followed by prolonged periods of superior real rates of return. In addition, in view of the negative 1.5% compound annual decline suffered by the S&P 500 (a negative 4.5% annualized loss net of inflation) over the past decade ending in 2008, the outlook for the next decade would appear to be favorable, purely on the basis of historical data alone.

Business Cycle Factors – There are two key free market factors that provide support to the phenomenon of mean reversion, one relating to the fluctuations of the business

cycle and the other relating to investor psychology. With respect to the traditional business cycle, a free market economy has a tendency to transition from favorable economic trends to intervals that are less favorable, as measured by economic growth, corporate profitability, inflation, and interest rates. The process of self-adjustment that is inherent in a free market economy triggers these swings in trends, which are in turn reflected in the behavior of financial markets.

Investor Psychology - With respect to investor psychology, markets have a strong tendency to move to extremes, both on the upside and on the downside, the result of the basic elements of “greed and fear.” Consequently, periods of weak market performance tend to become accentuated because of human nature, resulting in an oversold and undervalued market. That sets the stage for the subsequent interval whereby the market moves in the opposite direction. Conversely, periods of favorable economic conditions accompanied by a favorable trend in equity markets tend to produce “irrational exuberance” on the part of investors, inevitably leading to excesses in valuation and an overbought market. The market tendency is to “correct” or adjust this excess in valuation over the next cycle.

Government Bonds - There are several additional findings in the historical data that can be easily summarized. The first relates to the historic return on common stocks relative to that of government bonds. The study shows that stocks outperformed long-term U.S. Treasury bonds in 100% of all rolling 30-year periods since 1871. Additionally, according to the Siegel study, stocks outperformed government bonds during 95% of rolling 20-year periods, 90% of 10-year periods, and 82% of 5-year periods. Over the past decade ending in 2008, the cumulative return on government bonds of 5.2% compares with a negative return for stocks.

Why Stocks Beat Bonds - There are two factors that explain the consistently superior returns of stocks over bonds over very long time periods. The first is that as a riskier asset class, common stocks should produce higher returns in comparison with government bonds. Capital markets are priced to compensate investors with a higher rate of return for asset classes that are inherently more risky. The second point is that unlike government bonds, common stocks are the beneficiary of rising corporate profits, cash flow, and dividends that are the by-product of an expanding economy. The real growth in each of these economic variables tends to exceed the rate of inflation over long periods, thus providing a long-term rate of return for stocks in excess of the inflation rate.

Inflation and Bonds - The final point is the enormous advantage of stocks over bonds with respect to inflation. Inflation is the principal enemy of government bonds; conversely, it is possible for stock shareholders to profit from inflation over the long term. Investors in fixed-income instruments are vulnerable and defenseless in the event of an unanticipated acceleration in the rate of inflation. While the initial reaction to rising inflation is negative, common stocks will eventually act as an effective hedge against inflation as the revenues, earnings, and dividends of many corporations are able to increase along with rising inflation.

Equity Market Valuation - Virtually all traditional valuation methodologies indicate that the equity market is massively undervalued from a long-term perspective. Although valuation is a notoriously poor short-term market timing device, it is a relevant consideration. The current highly attractive valuations on common stocks provide patient investors with a favorable risk/reward ratio as well as a solid foundation for potentially superior long-term rates of return over the next decade.

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