

# MARATHON

## HISTORY SUGGESTS PATIENCE IN THE '90s

by Thomas J. Feeney

Imagine: the recession has ended; corporate profits reached their trough in 1991; earnings will now increase through the end of the century at the fastest rate of post-recession growth experienced over such a period in the past six decades; the 1990's will match the 1960's as the only decade since 1930 in which price/earnings multiples remain at or above their long term average throughout the entire decade. Who could ask for more? Surely these are the components of the great bull market to close the twentieth century.

But wait! Let's apply real numbers. If all of these remarkable conditions unfold, the probable increase in the S&P 500 to the year 2000 will be a compounded 4.2% before dividends. Should we experience average post-recession earnings growth and average PE multiples, the market will probably provide a negative total return between now and the end of the century. In other words, a \$1 million portfolio at the end of 1991 will be worth less than \$1 million at the dawn of the new millennium, even if not one dollar is spent or otherwise withdrawn from the portfolio for eight full years. Should dividends be withdrawn, the probable value of the original \$1 million at century-end would be a mere \$547,500.

Battle lines are drawn today between the stock market bulls, whose case rests largely on projected earnings increases from currently depressed levels, and the bears, who can't understand why anyone would risk capital at today's valuation levels. Clearly the bulls have taken control of the field. Apart from the argument about short term direction, a perilous debate at any time, is there reasonable rationale for the long term investor to remain heavily committed to equities under today's conditions? This analysis will examine the history since 1930 of all earnings

increases that followed recessions in which corporate earnings declined for at least one calendar year. It will also examine equity valuation levels in each of the last six decades, not simply to determine long term averages, but, to establish whether ranges of value recur from decade to decade. Given the range of past earnings recoveries and patterns of valuation experienced over 60 years, it is instructive to examine the probabilities of various potential stock market returns through the end of the century.

Since 1930, and prior to the 1991 recession, there have been ten recessions in which corporate earnings have declined in at least one full calendar year from the prior peak earnings year. To determine the probable range of earnings expectations for the remainder of the 1990's, we have examined earnings growth from the trough earnings years of such recessions over the ensuing eight years (enough time in the current instance to take us to the year 2000). Table I demonstrates that earnings growth from each of the ten qualifying recessions. The growth rates vary dramatically, often with

Trough Earnings Year	Annualized Eight Year Earnings Growth
1932	12.5%
1938	6.5%
1944	12.6%
1954	3.6%
1958	3.5%
1961	7.7%
1970	11.6%
1975	7.3%
1980	6.1%
1982	7.7%

TABLE I

negative correlation to the severity of the prior earnings decline.

Earnings, of course, tell only part of the story, and, if the last half decade or so is accepted as normative, they really don't matter much at all. On the other hand, maybe--just maybe--valuation levels that prevailed for more than half a century remain relevant. Table II lists the maximum and minimum levels of price to earnings in each

S&P 500 PRICE/EARNINGS RATIOS		
Decade	Highest P/E	Lowest P/E
1930's	26	10
1940's	22	6
1950's	19	7
1960's	23	14
1970's	20	7
1980's	23	8

TABLE II

decade from the 1930's through the 1980's. With few exceptions there is a remarkable consistency from decade to decade. When such consistency exists over a long span of time, it is difficult to argue for dramatic departures from the limits in future decades. Although we are limiting this analysis to price/earnings ratios, there is a similar decade to decade consistency in parallel analyses of price to dividends and price to book values. Since virtually nobody is arguing publicly for valuation levels above the highest or below the lowest that we have experienced in 60 years, let us accept those as the highly probable limits for the 1990's as well.

At more than 25 times 1991's \$15.97 earnings the S&P 500 is clearly beyond the typical decade's high price/earnings level. The present level was exceeded only in the 1930's when the earnings portion of the ratio fell 75% from its former peak year. Even if all extraordinary charges are fully recognized,

the current earnings decline pales in comparison with that earlier debacle. Still, today's valuations stretch for that all-time limit. Today's dividend levels are close to their historic lows and the price to book value of the S&P Industrials is beyond any prior level.

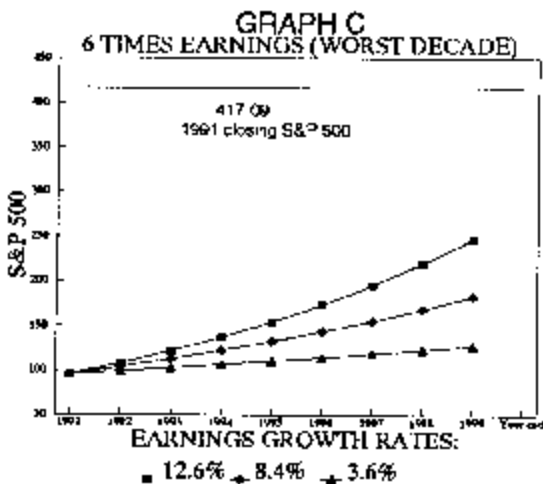
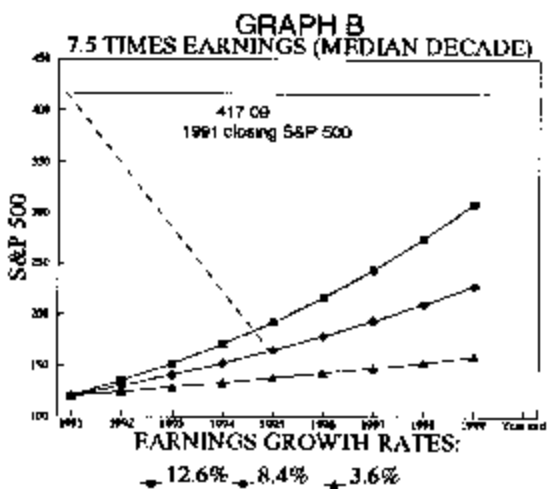
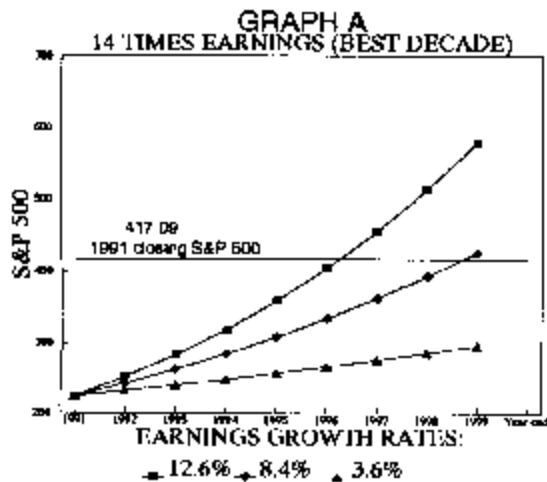
In every decade since 1930 the market's PE ratio has dropped to at least 14. As seen in Table II, it usually dips far lower. If the 1990's are not fated to be the decade of highest valuations in the last two-thirds of this century, we will at some point in the next eight years see the PE level at 14 or below. If we assume for simplicity straight line earnings growth throughout the decade, stock prices will intersect one or more of the trendlines in Graphs A, B, or C, which trace the path of the best, the average, and the worst earnings growth rates listed in Table I.

On Graph B we have shown an example of S & P 500 price behavior should the market achieve its low price/earnings ratio at the end of 1995, half way through our eight year analysis. For purposes of this example, we assume that the low PE multiple for the 1990's reaches the low of the median decade, and we assume that earnings will grow at the average rate that followed the prior ten recessions covered by this analysis. If all of these "average" conditions prevail, the S & P 500 will decline from 417.09 at the end of 1991 to 165.38 at the end of 1995. If we assume that four years of dividends will be withdrawn, a \$1 million original investment will then be worth \$396,500. That consequence is so dire there is a tendency to dismiss it as the apocalyptic forecast of the perennial doomsayers. Not so! This is the market level the history of the past six decades predicts to be most probable if that date should mark the point of this decade's low PE ratio.

This would not be an unprecedented erasure of prior gains. A decline to 165 at

## POTENTIAL S&P 500 LEVELS AT DECADE'S LOW PE RATIO

1991 EARNINGS = \$15.97



the end of 1995 would bring the S & P 500 back to where it ended 1983, eliminating any capital appreciation for a dozen years. When stocks tumbled in 1973-74 in response to the serious overvaluations that had prevailed since the mid-1960's, the S & P 500's decline wiped out all advances in the thirteen years after 1961. In the same collapse of stock values, the Dow Jones Industrials at their December 1974 lows declined to their levels of late-1958, effectively eliminating capital gains of more than a decade and a half.

Some might argue that earnings growth will be front-loaded. While that is possible, it is no more likely than the opposite course. Earnings growth from the trough year of the ten recessions in this analysis has been above its eight year trendline at its mid-point only half the time.

A compelling bullish condition to many is the massive decline in interest rates that characterized 1991. Even at levels rivalling the lowest in nearly 30 years, we are merely at average short-term rates for the entire twentieth century. Why should this be cause for better than historically normal earnings growth? In analyzing fundamental conditions we should never lose sight of the historically abnormal debt burdens that pervade all levels of our economy.

History argues that there is scant advantage for the investor to remain heavily in equities at today's levels. If past is even approximate precedent, the most effective approach will be to protect principal at current levels of overvaluation and effectively put limit buy orders beneath the market at more historically attractive levels of value. A more sophisticated and more productive approach is to employ a strategy designed to increase exposure to equities as valuation levels decline and systematically to minimize equity exposure as valuation levels reach toward historic highs. Except for the nimble and consistently successful trader (an

oxymoron?), no investor, prior to the current great bull market which began in 1974, has maximized returns long term from remaining heavily committed to equities at valuation levels even close to today's. Unless the 1990's become U.S. history's most consistently overvalued decade, there is little probability that simply remaining heavily committed to equities will prove to be a wise strategy for the 1990's.

Table III summarizes the best, worst and average cases for the years to 2000 employing the data on earnings growth and price/earnings multiples from Tables I and II. The return computation for each year reflects the annualized return to that date if the earnings growth has been linear and the low PE multiple for the decade occurs at the end of that year.

POTENTIAL ANNUALIZED RETURNS FOR S&P 500 BEFORE DIVIDENDS FROM YEAR END 1991			
SCENARIO:	Best	Average	Worst
P/E MULT:	14	7.5	6
F GROWTH:	12.6%	8.4%	3.6%
<u>Year End</u>			
1992	-39.64%	-68.87%	-76.20%
1993	-17.56%	-41.91%	-50.34%
1994	-8.53%	-28.48%	-36.55%
1995	-3.65%	-20.65%	-28.28%
1996	-0.60%	-15.54%	-22.80%
1997	1.49%	-11.95%	-18.92%
1998	3.00%	-9.30%	-16.03%
1999	4.16%	-7.25%	-13.80%

TABLE III

If the market plummets, as it typically has from valuation levels like today's, the opportunity to recommit capital more heavily in equities will present itself in the next few years. If historically normal valuation levels are reached more gradually in the latter half of the decade, realizing the benefits of history's guidance will require conservatism

today and patience for years to come. As seen from a comparison with Table III, accepting even the apparently low returns of today's secure, relatively short term fixed income securities should lead to better returns than will be available from equities for the remainder of the decade. If, however, a market decline leads to more attractive valuations early in the decade, there will likely be an opportunity to make a heavier commitment to normally valued or undervalued equities, which could then produce greater total portfolio returns by the end of the decade.

Because virtually no plan sponsors and portfolio measurement consultants truly employ and have patience for decade-long time horizons, few will stay such a course if the decline from today's lofty valuation levels does not materialize quickly. Most investment managers recognize that they will be fired if their investment thesis is not borne out within a few years, even if they are in concert with regularly repeated historical precedent. As a result, few managers will accept the risk of such a long term approach, even if they believe it to be correct. Impatience ultimately defeats most investors, and there is little reason to expect that to be different in the 1990's.

One horrible afterthought: What if 1991 didn't mark the trough in earnings or a brief recovery is to be followed by further earnings declines? The prior analysis will prove too optimistic.

May 19, 1992