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## Quarterly Investment Commentary | January 2010

### The Real Economy

The last quarter of 2009 turned out to underscore a real significant change in the economy. Real gross domestic product increased at an annual rate of 2.2 percent in the third quarter of 2009, (that is, from the second quarter to the third quarter).

Much of this growth reflected increased productivity associated with an increase in demand. Worker anxiety about losing their jobs and employer reluctance to expand could be largely responsible for some of this productivity.

More importantly, this turnaround in demand dramatically has probably reduced employer's defensive cost-cutting strategies. This change is reflected in the dramatic decline in new claims for unemployment. **Employers are not hiring very many new workers, but they are not downsizing as much.**

Unemployment rates, however, remain abysmally high, but the accumulation of evidence in favor of the recession's end has provided consumers and to a lesser extent employers a sense of confidence about the future.

The Conference Board's index of consumer confidence increased in both November and December. This is not, however, a time of celebration. Rather it is a time to take a big sigh of relief and hope that the future will be brighter.

**Unfortunately, employment rates might not increase for some time, but chances are good that neither will unemployment rates.** We remain optimistic that while real economic growth will be slow, it will be

November Benchmark Returns (Preliminary)		
Large-Cap Benchmarks	Nov	YTD
Vanguard 500 Index	6.0%	24.1%
Russell 1000 (iShares)	5.9%	25.3%
Russell 1000 Growth (iShares)	6.1%	32.8%
Russell 1000 Value (iShares)	5.6%	17.6%
Mid-Cap Benchmarks		
Russell Midcap (iShares)	4.8%	32.7%
Russell Midcap Growth (iShares)	4.6%	37.5%
Russell Midcap Value (iShares)	5.0%	27.4%
Small-Cap Benchmarks		
Russell 2000 (iShares)	3.1%	17.7%
Russell 2000 Growth (iShares)	3.1%	23.8%
Russell 2000 Value (iShares)	3.1%	11.9%
Other Benchmarks		
Vanguard Total Int'l Stock Index	3.9%	34.7%
Vanguard Emerging Mkt Stock Index	5.9%	69.9%
Vanguard REIT Index	6.9%	21.1%
Vanguard Total Bond Mkt Index	1.4%	7.7%
Merrill U.S. High Yield Cash Pay	1.0%	51.7%
Barclays 7 Yr Muni Bond Index	1.9%	8.2%
Citigroup World Govt. Bond Index	3.2%	8.0%
DJ-UBSCI (Commodity Futures)	3.5%	16.6%

steady, and that by the end of this year unemployment rates will have reduced substantially. We wish we could proclaim that unemployment rates will fall below 5 percent; but so far we are not that optimistic.

## The Financial Markets

Stocks, however, both in anticipation of future growth and in relief that the financial markets did not completely collapse surged this past quarter.

Leading the charge was the large-cap Vanguard 500 Index Fund (which replicates the S&P 500) with a 6% gain, bringing its year-to-date gain to 24%.

The iShares Russell Midcap was up 4.8%, and the small-cap Russell 2000 iShares returned 3.1%. Foreign stocks also had a good month, with the Vanguard Total International Stock Index Fund up

3.9%, and emerging-markets equities (based on Vanguard Emerging Market Stock Index Fund) gaining 5.9%, bringing their year-to-date gain to nearly 70%.

Turning to fixed-income, the intermediate-term, investment-grade Vanguard Total Bond Market Index Fund was up 1.4% for the month and is now up 7.7% so far in 2009. High-yield bonds, as measured by the Merrill Lynch U.S. High Yield Cash Pay Index, returned 1% for the month and are up 51.7% so far this year.

## Assessing U.S. Equity Valuations

Many investors want to believe that stock market valuation analysis is more science than art. In our view it is more art than science. As a case in point, consider long-term P/E ratios.

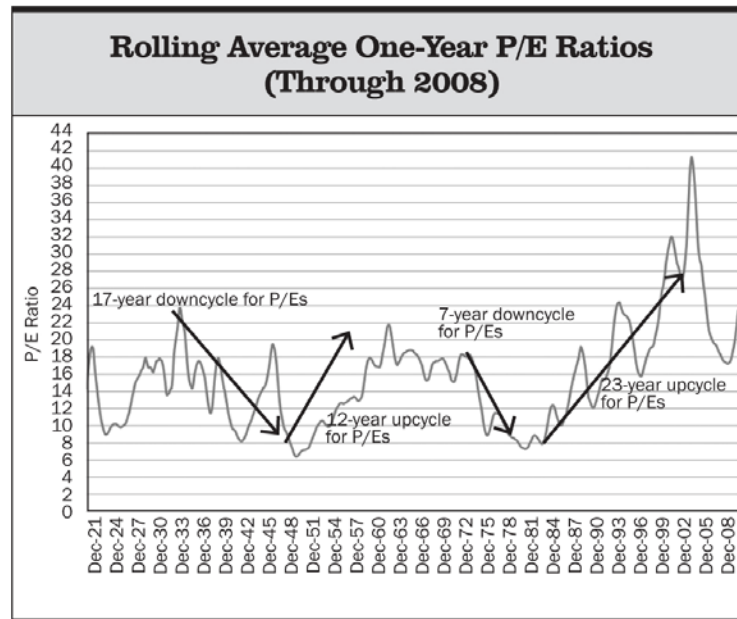


Chart 1: Economic crises (the Great Depression and the high inflation period in the 1970s) both led to very long periods of relatively low P/E ratios (under 14x)—for about 20 years after the Depression and for over 10 years during and after the 1970s.

- What would a snapshot of the P/E ratio mean at any point in time or in conjunction with looking to the past about stock prices going forward?
- While it is always clear where we have been, what does that tell us about the future? Forward-looking assessments can vary significantly over time. Think about what the world looked like in the early 1980s with inflation in the teens but heading much lower, versus today with inflation running at zero.
- Stocks compete with other asset classes so valuations have to take into account the other investment opportunities.

Our approach to stock market valuation starts with analyzing scenarios. We use scenarios because we believe, in part:

- 1) valuations should factor in a forward-looking view, but

- 2) nobody can consistently and accurately predict the future.
- 3) So we are far more confident anticipating a broad range of possible outcomes. We then do reality checks with other valuation metrics and other variables such as trailing-return analysis.

## Five Year Scenario Analysis

We array four scenarios ranging from optimistic to pessimistic. Each scenario is based on a big-picture view of how key variables might play out. ‘

In our most optimistic scenario we assume that we have close to a normal recovery from the recent recession. In our most negative scenario we assume the current recovery is not sustainable, resulting in a recession in 2010 or 2011 with some deflation over the next few years.

In general, our scenarios factor in the realities of financially stressed households and banks that will require debt reduction relative to assets and income, stretched government resources, and the risk of unintended consequences and outright mistakes as policy makers try to manage through this highly challenging environment.

We also consider positive factors. For example, we could see healthy corporate investment if business spending that had been put on hold is reversed and corporate cash flow could be healthier than expected given aggressive cost cutting and high productivity. We also consider the possible impact on earnings if strength in a number of emerging markets results in stronger than expected export growth.

Our analysis is also informed by what happened in other cycles with a similar debt/asset bust. This part of the analysis considers the general economic environment and how it impacted specific variables, particularly corporate earnings in the years that followed.

Our scenario approach allows us to consider a range of possible impacts on the overall economy, which we use to build a five-year corporate earnings forecast for each scenario. We regularly tweak our forecasts as we get new information and insights.

The most optimistic scenario assumes that earnings return to their long-term trend-line in five years. This would require a high level of earnings growth, although lower than we saw in the 1990s.

## Additional Valuation Metrics

**Shiller P/E**—This metric, based on the work of Yale professor Robert Shiller, normalizes reported earnings to smooth out the huge cyclical ups and downs in an attempt to get a better measure of

The worst scenario assumes that earnings initially rebound from their trough at the median post-WWII growth rate during an expansion, and then revert to the average long-term growth rate of 6% per year.

We come up with a P/E multiple five years into the future for each scenario. The multiple is based on an assessment of how the environment we envision is likely to influence investors' appetite for risk. We also factor in possible inflation and interest rates. In our most optimistic scenario we assume an 18x multiple—the average long-term historical multiple during periods of moderate inflation and normal economic growth. In the most negative scenario we assume investor-risk appetites are depressed and so even though depressed earnings normally are associated with higher multiples, we assume a lower multiple of 16x.

Currently our range of earnings goes from a low of \$54 and a high of \$92 (reported S&P 500 earnings five years out). With the S&P 500 at a level of about 1,100, our range of annualized five-year returns is -2% to 11% (annualized). We believe both extremes are unlikely. **However, the likelier return range, looking at all of our scenarios, is in the low to mid single-digits.**

This suggests stocks are currently overvalued unless our more optimistic scenario plays out, in which case stocks would be fairly valued. However, the overvaluation may not be as extreme as it appears if we lengthen our scenarios to 10 years. Over that longer time period it is more possible that we would see a move back closer to the long-term earnings trend resulting in better odds that stocks will return in the mid to high single-digits. However, we are not confident this will happen over a five-year time horizon.

In assessing valuation, we place a significant amount of judgment using our scenario analysis. However, we also consider other more immediate metrics. The following is an overview of some of these additional metrics.

normal earnings power for the overall stock market (as measured by the S&P 500). It does this by adjusting earnings for inflation and averaging the earnings over 10 years. It then uses an inflation-

adjusted S&P 500 price to calculate a normalized P/E. We think this metric has merit. *Currently the Shiller P/E (shown in Chart 2 below) suggests stocks are a bit pricey. At almost 20x normalized earnings the P/E is above its very long-term*

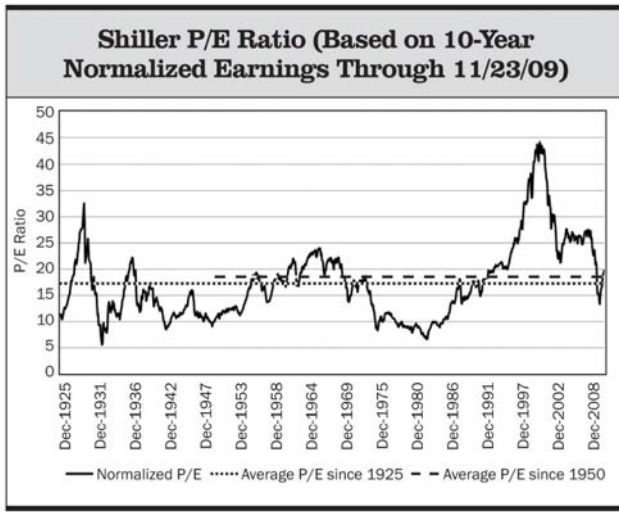


Chart 2

**Median S&P 500 P/E**—The median S&P 500 P/E is another useful measure because it eliminates possible skewing of data from the traditional market-cap weighted S&P 500 P/E. As of November 23, it was 21.6, above its long-term average (using data back to 1968) and above where it had been except for the late 1990s and earlier part of this decade. *This measure also suggests stocks are somewhat overvalued.*

**Price-to-Sales (P/S)**—This ratio is useful because sales are less prone to accounting manipulation than earnings. In addition, it also eliminates the impact of fluctuations in profit margins, which over the long run tend to revert to the mean. Currently, the P/S for the S&P industrials suggests that stocks sell in the range they did through the late 1950s and 1960s, below the level of the last 15 years but quite a bit higher than in the 20-year period ending in 1995. This data series is somewhat skewed by the very high P/S level that stocks sold at in the late 1990s and earlier this decade. *If we eliminate that period, the current level of P/S suggests stocks are in the upper ranges of fair valuation to somewhat overvalued.*

average. And a close look at the scatter plot (Chart 3) below shows that the majority of times when the P/E was around 20x, returns over the following 10 years were between 5% and 10%.

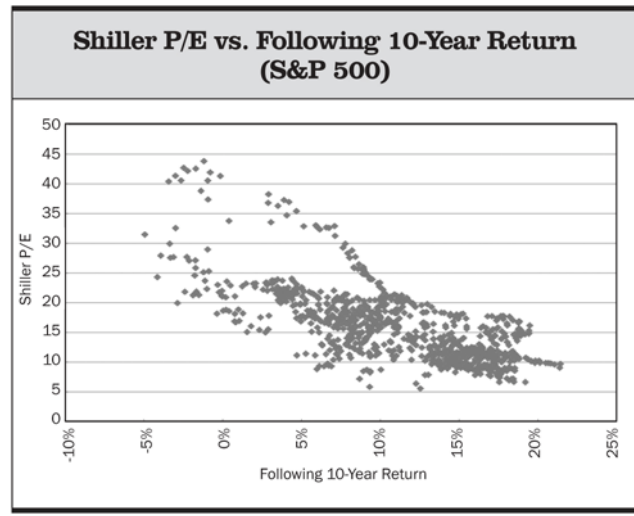


Chart 3

**National Income and Product Accounts (NIPA) P/E**—This measure uses after-tax profits captured from tax returns from all U.S. corporations (public and private). A problem with this data is that it takes a long time to collect and finalized. On the other hand, unlike accounting profits, profits reported for taxes are not likely to be manipulated to make them look better than they are. Over the past 15 years, this P/E has been in a higher range than at any other time since the data series began in 1950. *The most recent measure we have was as of June 30, 2009, and it remains high and does not take into account the 20% rise in the stock market since midyear.*

**Dividend Yield**—Historically, dividends have been a major driver of stock market returns. According to Ned Davis Research they have accounted for 79% of the S&P 500 return since 1959 and 57% of total return since 1989. In any decade starting with the 1930s, the dividends have never accounted for less than 22% of the stock market return. Currently, the S&P dividend yield is approximately 2.2%, a very low historical level (see Chart 4). *This is one of the most disconcerting valuation measures.*

## S&P 500 Dividend Yield (Through 11/09)

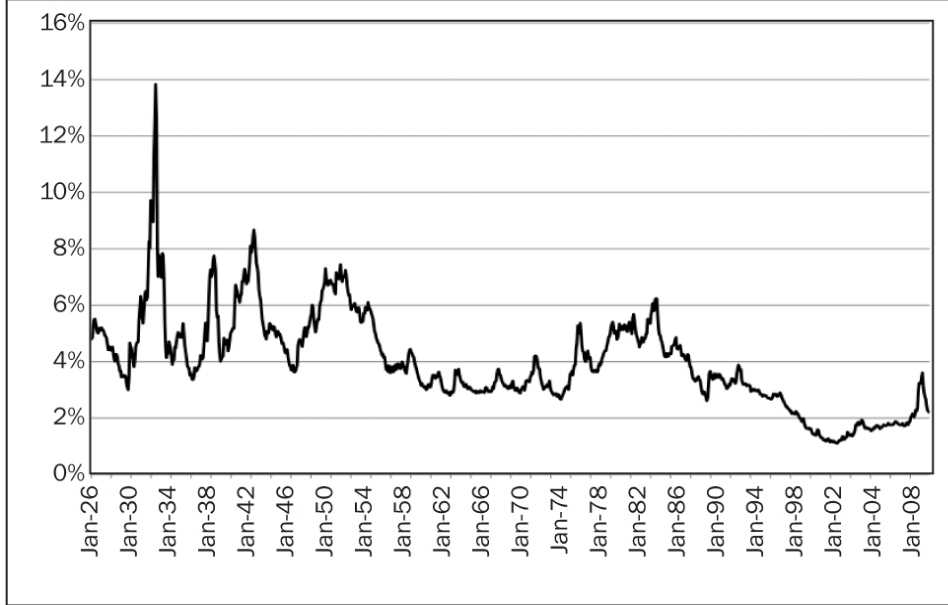


Chart 4

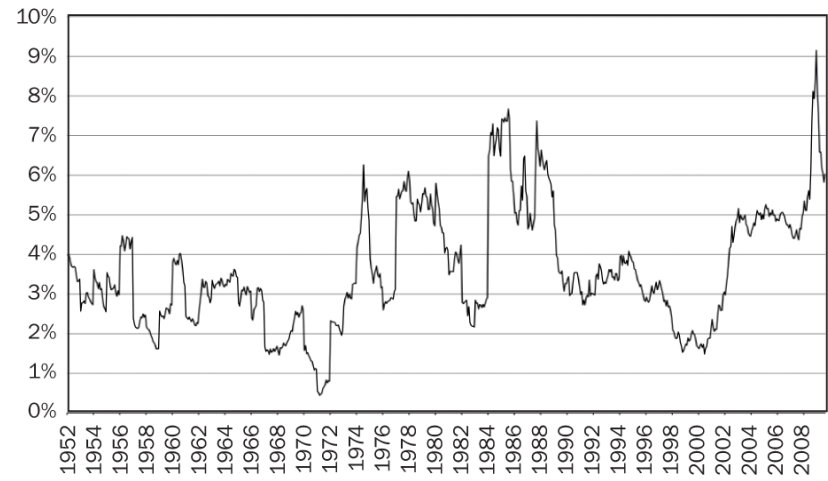
**Price to Free Cash Flow (P/FCF)**—This is the one valuation measure that is clearly at odds with all the other metrics. As depicted in Chart 5, the P/FCF is higher than it has been during most of the period spanning the last 57 years, suggesting that valuations are attractive.

A key reason why this metric looks better than others is that companies have held back on capital investments (investments in plant and equipment) for some time, resulting in higher cash flow. Empirical Research Partners, an independent research firm, believes that some of the reduction in capital investments is permanent, largely because more and more manufacturing is being moved to emerging markets where costs are lower.

We suspect that some of the high free cash flow yields are due to temporary factors. We believe that eventually, investments in plant and equipment will have to increase. But, we are unsure how quickly that will happen. More importantly, we are unclear whether a material amount of the reduction may in fact reflect a permanent reduction in required capital expenditures, and if so how much of an impact this will have.

If it is material it may suggest stocks are more attractive than they appear based on other metrics. But for now we don't find this story compelling enough to offset the weight of the evidence from other valuation metrics.

## Large-Capitalization Stocks' Free Cash Flow Yields (1952 Through November 2009)



Source: Corporate Reports, Empirical Research Partners Analysis.

Chart 5  
*Capitalization-weighted data.*

### Return-Based Metrics

**Trailing Returns**—Looking backwards at returns can provide a reality check to our valuation work. For example, from August 1982 through the peak in March 2000, stocks returned almost 20% per annum. Common sense would suggest that a long run of supercharged performance like that would result in an overvalued market. What about now, with stocks down over 10 years? Does that suggest stocks are cheap? Not necessarily, because even though stocks have had a horrible 10 years, that

period followed the great bull market of the 1980s and 1990s. If we look at returns over the last 30 years, which encompasses both the strong and weak stretches, stocks have returned over 11%. *Long-term trailing returns support a conclusion that stocks may be in a long-term fair value range.* In that sense, this is a more encouraging metric than the weight of the evidence from the valuation measures discussed earlier.

### S&P 500 Trailing Returns (Through 10/31/09)

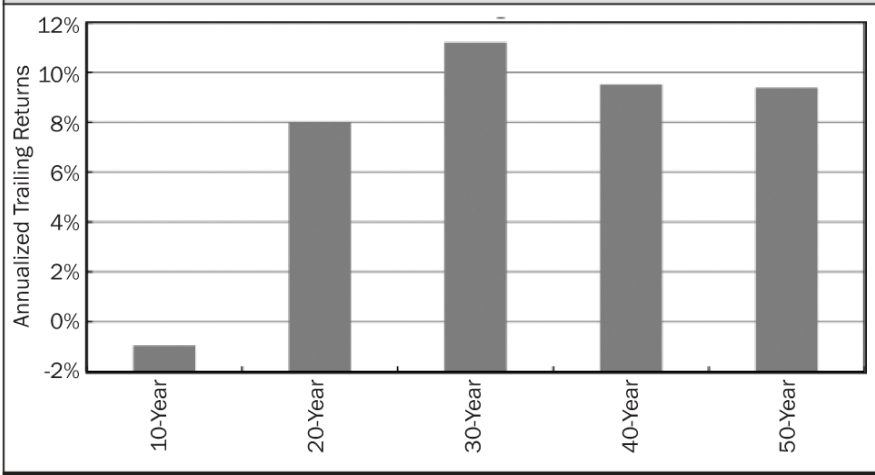


Chart 6

**Trailing Risk Premiums**—Trailing risk premiums compare trailing stock market returns to the return from the risk-free rate (a T-bill return or money market fund return).

Looking at this metric we see that the trailing risk premium over the last 10 years is negative and among the lowest ever. *Generally, this suggests that future returns are likely to be strong.* However, as with the trailing return metric, we have to remember that even though the trailing 10-year risk premium is very low, the risk premiums over most

of the two decades prior to that included a huge secular bull market and were much higher.

It is also worth noting that in past periods when the risk premium collapsed over 10 years, stock returns in the subsequent five years were generally good but not always—some of the five-year return periods that followed were only in the low single digits and there were a few that were negative (mostly these were in the 1930s). If we look at the subsequent 10-year periods instead of five, returns were always at least decent (the lowest annualized returns of 7%).

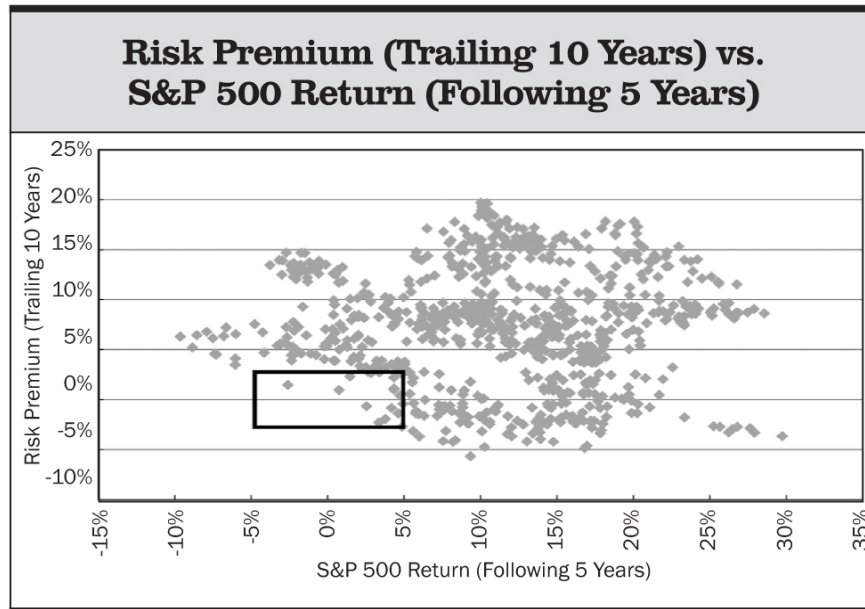


Chart 7

## The Limits of Valuation Metrics

There are two important issues to address regarding the types of absolute valuation metrics just discussed.

**Timing:** Valuation analysis is not reliable as a timing tool. We've seen plenty of examples over the years where stocks can stay cheap or expensive for stretches lasting many years. So we don't expect to be able to make money over the short term based on valuations. However, when valuations are extreme, we can factor that into our portfolio strategy and we believe we are likely to be rewarded over five years and often sooner.

**Interest Rates and Inflation:** Valuations are often influenced by interest rates. When rates are low and stable, investors are willing to pay higher prices for stocks. This makes sense for a number of reasons. Perhaps the most intuitively appealing reason is that if investors can't capture attractive returns through their fixed-income investments they

are more willing to take more risk to try and capture higher returns elsewhere.

On the other hand, when interest rates are very high, they have less motivation to take on the risk inherent in the stock market.

However, there may be more to this relationship than simply the levels of rates. Interest rates are closely tied to price levels (inflation) and overall economic health. Extremely low (deflation or near deflation) or extremely high inflation rates are likely to coincide with deep economic problems and risk. For example, in the late 1970s and early 1980s when inflation reached the teens, there was great pessimism that it would ever get back into single digits. Conversely, during the Great Depression, the economy suffered from serious deflation, and investors were fearful of the economic consequences if deflation was not quickly reversed. In both these periods valuations became

depressed—for example, single-digit P/E ratios existed during both periods. *Given the significant economic stresses that are likely to be with us for a while, we think it is unlikely that there is significant upside to valuations from current levels.*

A byproduct of depressed valuations that accompany periods of extreme economic stress is an extended reduction in investor risk appetites.

## Summary

No one has a crystal ball, but assessing possible scenarios allows us to better understand the opportunities and risks, and make, we believe, more-informed decisions

Based on the range of returns forecasted by our scenario analysis, *stocks appear overvalued over our five-year time horizon. Looking out over 10 years stocks may be somewhat closer to fair value.* Only in our most optimistic scenario do stocks look likely to deliver historically average returns over the next five years. (This conclusion refers to U.S. equities on average—not all stocks are overvalued and we may continue to be in a period where skilled active management can add value over index benchmarks.)

We rely on scenario analysis because it considers the fundamental outlook as well as a range of possible valuations. This allows us to consider more information than standard metrics that are limited to a single point-in-time look at valuation.

However, we still keep tabs on a variety of metrics. *Looking at valuation metrics, the weight of the evidence also suggests that stocks are somewhat overvalued. Metrics based on trailing returns and trailing risk premiums, however, suggest stocks are in a fair-value range—but only when we consider trailing returns over very long periods.* If we looked only at the last 10 years without the context of the lengthy bull market that came before, we would be inclined to conclude that stocks are probably undervalued.

Overall, the weight of the evidence is generally in line with our scenario work *though our scenario-based outlook is somewhat more pessimistic* than the general message from other more standard metrics.

Fear related to economic instability, along with a healthy respect for risk that comes from living through a once-in-a-generation (or worse) bear market, has historically left investors unwilling to price stocks at high valuations for years. We can see this by looking at long-term P/E trends in Chart 2 earlier in this article.

*The difference can be rationalized by our concern for continued deleveraging.* In addition, over time there is likely to be increasing risk from a financially stretched government sector.

We do recognize the possibility of a better outcome and more normal recovery that would result in stock market returns of over 10% over the next five years. But we view this as a low probability scenario.

In the scenario we consider most likely, we view the top end of the fair value range for stocks as 1,000 on the S&P—about 10% below late November levels.

Given our outlook we continue to underweight U.S. equities (though a portion of that underweighting is offset by exposure to high-yield bonds, which have equity characteristics).

Foreign equities (in developed markets) are in a similar valuation range to U.S. equities, and our exposure to them is also underweight, but to a smaller extent than U.S. equities.

The reason is primarily because as we look ahead and think about adjusting our strategic/neutral asset class target allocations—for the first time in 10 years—we anticipate a somewhat higher target for non-U.S. equities.

Currently we are overweighted to emerging-markets equities because return ranges in all of our five-year scenarios are higher, though this overweight slightly increases our potential portfolio volatility in the shorter term. Taken together, these tactical shifts net out to a modestly risk-averse positioning.

## A New Year Resolution

We want to thank you for continuing to recommend us to your friends and relatives. We view this as the highest compliment a client can make. While we are pleased with the complements, we are busier than we ever expected.

The growth in our practice, in conjunction with preparing for, taking, and passing the day and a half examination required to become a Certified

Financial Planner, resulted in our stopping these commentaries.

It is our intent to maintain this commentary every quarter. In addition we plan to provide at least one general financial planning summary every quarter.

To maintain this schedule and meet client obligations we plan to expand our capacity by hiring more help.

## About Friedland Financial Planning

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### We Help Families Plan for Life

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