

BARNETT & COMPANY

INVESTMENT COUNSEL

Quarterly Review and Outlook

3rd Quarter 2011

Boomerangst

Any way you slice it, the third quarter was lousy. Concern that the tepid recovery might slip back into recession was heightened by the embarrassingly inept handling of the debt ceiling increase. Add to the mix an intensifying sovereign debt crisis in Europe highlighting the quixotic nature of the monetary union and threatening to expose again how over-leveraged the world's largest banks still are. Stir in an unpassable jobs plan conceived to function as the season's first Presidential campaign speech, and top it off with a self-inflicted downgrade of America's credit rating. Send it to Congress for half-baking, and you have the ingredients for a serious selloff. Perhaps the big surprise was that the market retreat wasn't even uglier.

US equity investors reached for the antacids after a 13.9% decline in the S&P 500 index, falling perilously close to bear market territory. The Dow fared a bit better, down 11.5% while the NASDAQ gave up 12.7%. Foreign markets performed even worse, with the MSCI-EAFE index down 19.0% and Emerging Markets tumbling 22.5%. If there was a bright spot, it was US Government debt, rallying in the "flight to quality" trade to produce a yield of 1.7% on the 10-year Treasury bill. That is the lowest return on the 10-year since the 1940s.

These are the times during which we dust off the bromides about staying the course

and sticking to an asset allocation strategy. Time in the market, not timing the market. Active management can't outperform passive indexing. These are still offered up each day to nervous investors, encouraging them to stay passively invested and let the inevitable upward bias of the market salve their cuts over time. But clearly this strategy did not work over the past ten years in the US, or the past two decades in Japan. This has led many investigators to question the received wisdom of passive indexing in view of the prodigious demographic shift under way.

Zheng Liu and Mark Spiegel of the Federal Reserve Bank of San Francisco have published a thought-provoking paper that has challenging implications for stock returns in the years ahead. Their work suggests that the average price-to-earnings ratio (P/E) for stocks varies over long cycles and is correlated to population waves. They construct a model based upon predicted population shifts as the baby boomers move into retirement, and argue that as a result the P/E ratio will continue to decline through 2025. By applying these projected P/Es to the average long-run rate of earnings growth, the authors make the case for zero real growth in stock prices over the next decade. This conclusion runs counter to Wall Street's perennially Panglossian exhortations, but is consistent with work done by Professor Robert Shiller

Quarterly Review and Outlook

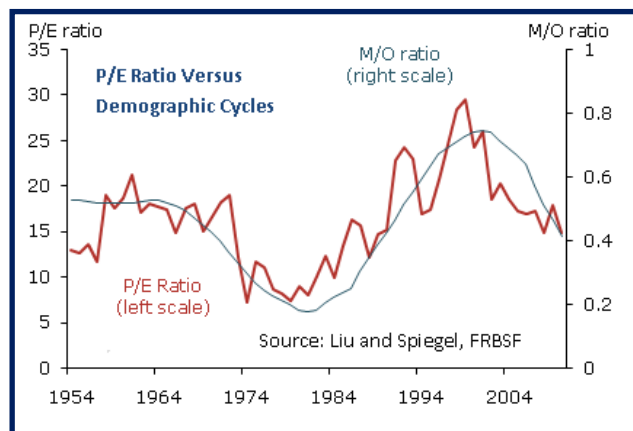
based on a variant of the P/E that smoothes out yearly earnings over a trailing 10-year period. Shiller, too, expects multiples to contract and stock returns to flatten.

The San Francisco Fed paper builds upon earlier work (Abel, Geanakoplos) that looked at demographic factors influencing stock returns. It is well established that investors calibrate their risk tolerance during different phases of their life cycle. Owing to its sheer size, the baby boom generation has had a major impact on capital markets, contributing to an extended bull market through the '80s and '90s as they entered their peak earning and investing years. With the boomer generation moving out of the workforce and into Sun City, they should be expected to sell stocks to attenuate risk and finance consumption in retirement.

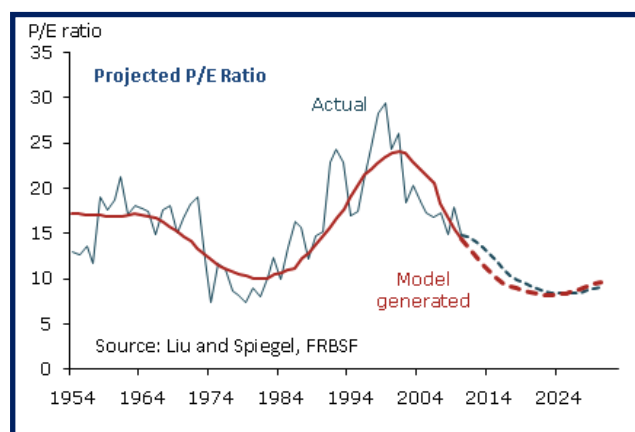
In order to investigate this hypothesis, Liu and Spiegel divided the population into 10-year age cohorts. They then defined the ratio M/O of middle age (40-49 years old) to old age (60-69 years). The M/O ratio would decline as more boomers move into the old-age cohort in the denominator and a smaller subset of middle-agers progress into the numerator.

Next, they compared the historical value of the P/E ratio for the S&P 500 index to the value of the M/O ratio. The results are fascinating. As shown in the associated chart, a high correlation between the relative size of the age cohorts and the earnings multiple emerges. Specifically, the P/E rises when the population is younger and contracts as the size of the older generation increases. As the multiple shrinks, stock price appreciation slows in response to a given rate of earnings growth. This can be seen during the long bull

market of the 1980s and 1990s: as the M/O ratio increased from 0.18 to 0.74, the P/E for the S&P 500 rose three-fold from 8 to 24.



Now, however, the worm has turned, and the boomers are moving on from the middle age cohort to the old-age class. In boomer parlance, O is the new M. In any event, if the Fed investigators are correct, one would expect the P/E ratio to fall, and continue declining for some time. By projecting the infeasible demographic shift ahead in time and applying the observed historical relationship of the earnings multiple to the M/O ratio, the authors expect the P/E to continue falling to a low of around 8.3 by 2021.



If this relationship holds over the next decade (as it has since 1954), what are the implications for stock investors? Suppose that nominal earnings continue to expand

Quarterly Review and Outlook

at their long-run average annual rate of around 6%. According to Standard & Poor's, the S&P 500 had as-reported earnings of \$88 for the 12 months ending 9/30/11. That implies an annual profit figure of \$158 in 2021. Applying the projected P/E ratio of 8.3 yields a value of 1,308 for the index, or a compound return of just 1.46% *per year* over ten years. Assuming a relatively tame inflation rate of 2.5%, index investors would find themselves *losing* 1% per year in real terms.

Of course, this is a hypothetical exercise, and many possible variants could be suggested; for example, it is possible that US investors might substantially increase their exposure to international stocks. However, a strong native country bias has long been observed and would have to be overcome. Even so, such a shift would mitigate but not erase the primary effect. Even under an optimistic scenario in which the P/E merely holds constant at the current 12x, the S&P would struggle to eke out 5% per year between now and 2021.

Many analysts suggest that earnings are likely to grow more slowly than the historical average, due to the ongoing deleveraging of the US economy and the expectation that recent record profit growth is unsustainable. If earnings growth averages a more modest 4.5% per year, and the predicted compression in P/E is realized, equity returns would flatline for ten years. Not a very encouraging prospect.

2021 P/E Ratio	Assumed Earnings Growth Rate	Expected Earnings 2021	Projected Value of S&P 500	10 Year Annualized Return
8.3	6.00%	\$158	1,308	1.46%
10	6.00%	\$158	1,576	3.37%
12	6.00%	\$158	1,891	5.28%
8.3	4.50%	\$137	1,134	0.03%
10	4.50%	\$137	1,367	1.91%
12	4.50%	\$137	1,640	3.79%

The 19th century philosopher Auguste Comte observed that demography is destiny. In the 21st century, the baby boom generation drives the demographic train as they advance into retirement at a rate of 10,000 per day. And they will live longer in retirement than any generation in history. This has profound investment implications.

Myrmidons of buy and hold, traditional asset allocation, and passive indexing are likely to be disappointed. Investors will need to be more tactical over the next decade, paying more attention to macroeconomic factors and focusing greater attention on sector selection. They will also need to place more emphasis on risk management, since the upside potential seems likely to be less robust. Portfolios will need to migrate toward substantially higher allocations to foreign stock and bond markets. Custodians will eventually need to provide greater access to international exchanges and allow foreign investments to be held in US client accounts.

Investors should also expand their exposure to other asset classes, including pass-through securities (MLPs, REITs, etc.), preferred securities, high-yield bonds and commodities. It will be especially important to emphasize cash flows through dividend and interest payments in an environment of constrained capital gains.

In the 1967 film "The Graduate", Dustin Hoffman is given one prophetic word of advice: "plastics". Nearly 45 years hence, the graduates are retiring, and the new watch phrase is: "artificial knees".

Christopher A. Hopkins, CFA
© 2011 Barnett & Company