

August 2009

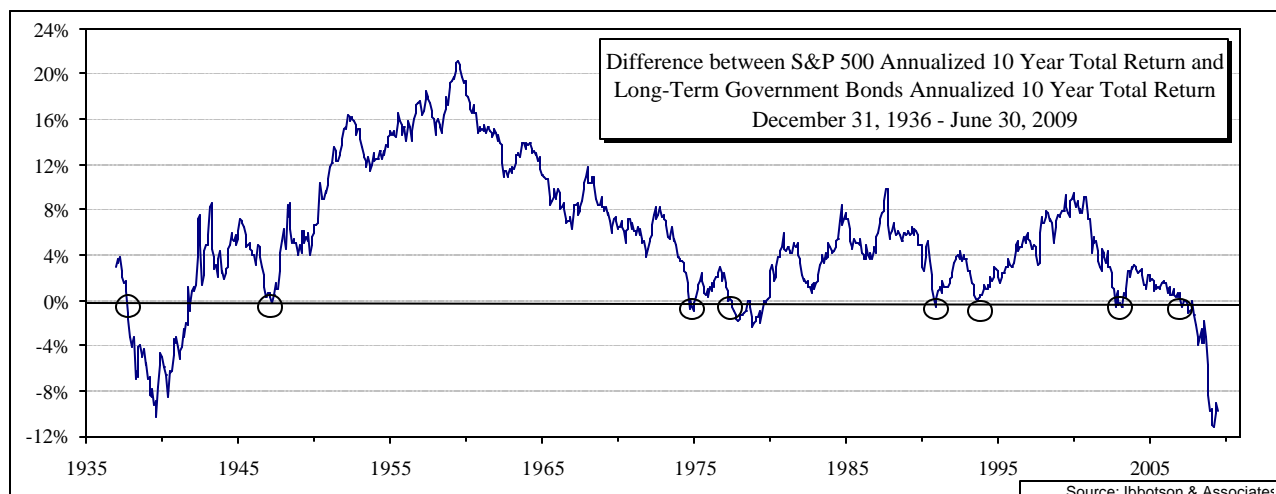
Market Commentary: Stocks, Bonds, and Long-Term Returns

In the June Market Commentary, we wrote about the importance of a well-functioning fixed-income market, especially as a prerequisite for stock market gains. Since then, we have seen a continuing improvement in fixed-income markets, and stocks have followed course.

The media and some prognosticators in the investment profession have brought attention to the fact that over several time periods, stocks have performed nearly the same as or have even underperformed bonds. This statement, coupled with the pronounced lift we have seen in the market since early March, might have some of you asking, "Is now really the time to invest in equities?" or "Are stocks even that much better than bonds in the first place?" Both questions are legitimate. In this month's market commentary, we will address the following:

- A continuation of the stock vs. bond tradeoff argument
- Why, even with the lift in stock markets since March, we believe equities present attractive long-term risk/reward potential

It is true that over the ten year period ending June 30, 2009, the S&P 500 has underperformed long-term government bonds ("Long-term" here refers to U.S. Treasury Bonds with 10-30 years to maturity). The S&P 500 registered an annualized total return (price change + reinvested dividends) of -2.2% for the ten years ended June 30, 2009. Long-term government bonds, over the same time period, yielded 7.6% annually to investors. This results in a differential of -9.8% (i.e., stocks underperformed bonds by 9.8% per year over the last ten years). Long-term government bonds have also outperformed stocks over holding periods of twenty and thirty years through June 30, 2009. This is likely very discouraging for some equity investors. The chart below shows the difference between the annualized 10 year total return of the S&P 500 and long-term government bonds. The circles represent points in time where bonds initially outperformed stocks over the previous ten years.



What many commentators fail to point out is when the stock market has underperformed the bond market over the preceding ten years, the stock market, on average, has gone on to do very well. How well? Table 1 below shows the average annual performance of stocks and long-term government bonds one, three, five, and ten years later from points where the S&P 500 initially began underperforming long-term government bonds over the previous ten years (for clarification, these points are circled on the chart found on the first page).

Table 1:

Subsequent Performance (Annualized Total Return)				
	1 Year Later	3 Years Later	5 Years Later	10 Years Later
S&P 500	11.0%	12.1%	13.0%	14.1%
L-T Gov't Bonds	4.6%	6.3%	5.8%	6.6%

Source: Ibbotson & Associates

The second table shows the growth of \$1,000 over the next one, three, five, and ten years at the rates shown in Table 1.

Table 2:

Growth of \$1,000 at the above rates				
	1 Year Later	3 Years Later	5 Years Later	10 Years Later
S&P 500	\$1,110	\$1,409	\$1,846	\$3,752
L-T Gov't Bonds	\$1,046	\$1,200	\$1,323	\$1,894

Source: Ibbotson & Associates

Warren Buffett's quote, "In the business world, the rear view mirror is always clearer than the windshield" couldn't be more relevant. It is also important to look at the periods where stocks underperformed bonds and ask why that happened. Two such periods which stand out on the chart shown on the first page are the late-1930s and today. The ten-year period ending in the late-1930s began with the late-1920s, and the ten year period ending June 30, 2009 began in the late-1990s. One similarity between the late-1920s and the late-1990s was lofty stock market valuations. If you were to fast forward ten years after the late-1920s and the late-1990s, you'd find that stocks, as measured by a normalized price/five year average earnings ratio, had become much cheaper than the period ten years prior (for more information on historical market valuations using normalized P/E ratios, see the November 2008 EBS Research Perspective). You would also find that over those ten year periods, government bond yields fell, driving up the prices—and total returns—of bonds.

In closing, though it will certainly take some time before we *feel* good again about the economy and the future prospects of our country as a whole, there is an abundance of compelling data supporting the rationale for why we believe this is still a fine buying opportunity for the long-term investor. We remain committed to following a disciplined process of buying partial ownership stakes in what we believe to be high quality companies trading at attractive price-to-value relationships.

As always, we appreciate the continued opportunity to serve you. Please do not hesitate to call with questions or comments.

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