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November 2008

Research Perspective: A Rational Analysis during Emotional Times

Year-to-date, 2008 has been one of the most painful years for stock market investors in the past 180 years. Only in 1931 did the market perform worse. The poorly performing stock market has wreaked havoc on investment portfolios and has turned investor fear into outright panic. The good news is that after similar periods in the past, stocks recovered nicely and generated very attractive returns for many years.

While our last research piece discussed bear markets, price volatility, and staying invested through difficult markets, this research report touches on the following topics:

- Historical Market Valuation and Investment Returns: We believe the U.S. stock market is cheap and should generate strong returns in the years to come. Historical data supports this view.
- Investment Performance after Poor U.S. Stock Market Returns over 10-Year Periods: When the market's 10-year track record was subpar in the past, the returns going forward were impressive.
- Other Observations: Stock dividend yields are above U.S. Treasury Bond yields for the first time since the early 1960s; the percentage of stocks trading below 10x earnings is the highest since the 1982 market lows; and when Warren Buffett writes it is worth paying attention.

Historical Market Valuation and Investment Returns

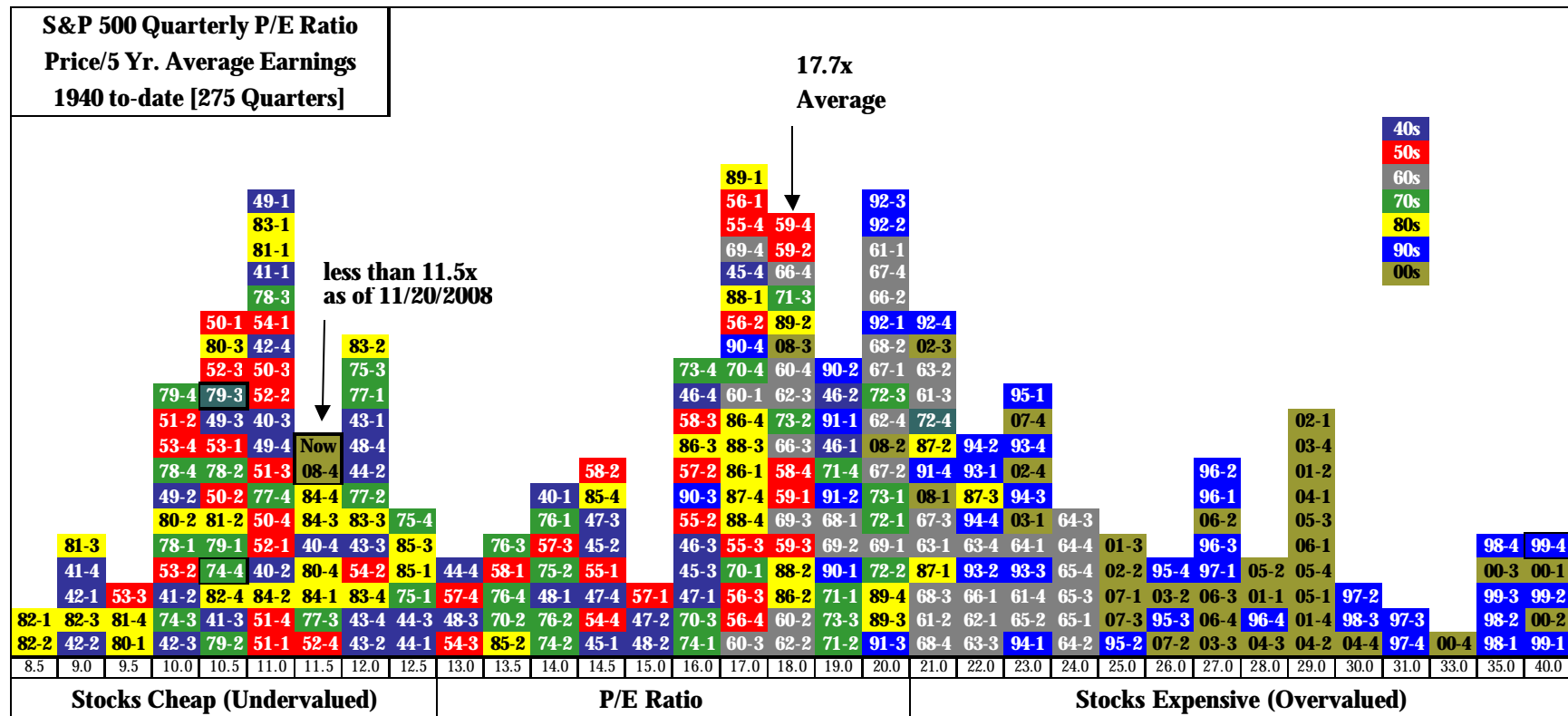
The U.S. stock market is cheap.

To provide some historical context, we compared today's valuation with quarterly valuations going back to January of 1940 (nearly 7 decades of market and economic history). We used price-to-earnings ratios (P/E) for the stock market as the measure of value. The P/E indicates how much an investor has to spend to purchase \$1 worth of a company's (or the market's) earnings. The methodology we used is described below and the results are illustrated in Table 1

Methodology:

- We reviewed the time period of January 1940 to September 2008 and divided each year into quarters (3 month periods), which resulted in 275 quarters.
- A price-to-earnings ratio (P/E) was calculated for each quarter.
 - The “price” component is the S&P 500 index’s price at quarter-end.
 - The “earnings” component is the S&P 500 index’s average annual earnings-per-share (EPS) for the prior five years. We calculated the earnings in this manner to reduce the volatility of earnings that occur from year-to-year. This “normalized” earnings number is more reflective of the average earnings power of the companies comprising the S&P 500.
- Each quarter is color-coded based on which decade the reading is from, e.g. all quarters in the 1940s are purple colored rectangles.
- Each quarter is identified by a two digit year followed by the quarter, e.g. first quarter of 2008 is 08-1.
- Each quarterly P/E is plotted on the distribution table (Table 1) with the lowest (cheapest) reading starting on the left and the highest (most expensive) reading ending on the right. The bottom row of numbers is the P/E range.

Table 1



Source: Standard & Poors, EBS Analysis

The current P/E is in the 11.5 column and is identified by the rectangle with “Now” in it. The reading falls in the 22nd percentile. Roughly half of the cheaper readings, those to the left of “Now”, occurred when interest rates were much higher than today (second half of the 1970s and first half of the 1980s). Higher interest rates made those P/Es relatively less attractive than today’s P/E given the current low level of interest rates. Why? When interest rates are higher and offer more competitive returns, stocks correspondingly will need to be priced cheaper.

An alternative way to compare P/Es to interest rates is to convert the P/Es to E/P ratios. The E/P, or earnings yield, makes a direct comparison easier. **The current P/E of 11.5x equates to an earnings yield of 8.7%. This compares to a 10-Year U.S. Treasury Bond yield of around 3%.** Not since the mid-1960s have earnings yields for stocks been this far above treasury yields, a positive for stock investments.

Next, we sorted the P/Es from lowest to highest and placed them into one of five groups. The first group was comprised of the lowest P/Es and the fifth group included the highest. For each group we calculated the average total return (price change plus dividends) of the S&P 500.

Chart 1 summarizes the cumulative and annualized total returns of the S&P 500 (SPTR) for the five years following each P/E group. Chart 2 does the same thing for a one year horizon. The results, over the better part of seven decades, show that the **lower the P/E, the better the average return that followed**. The current P/E of 11.5x falls just above the first group (8.0-11.0). If historical trends continue, this should bode well for future stock returns. See Appendix A for greater detail.

Chart 1: 5 Year Returns

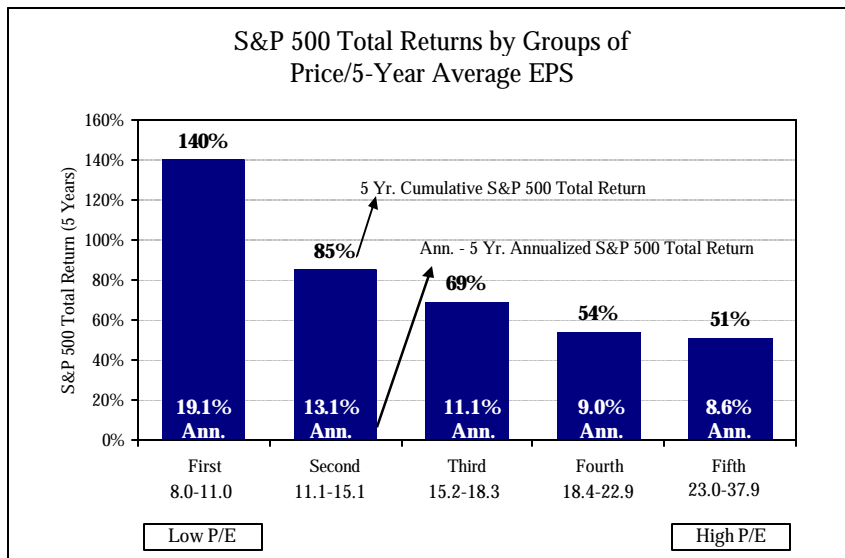
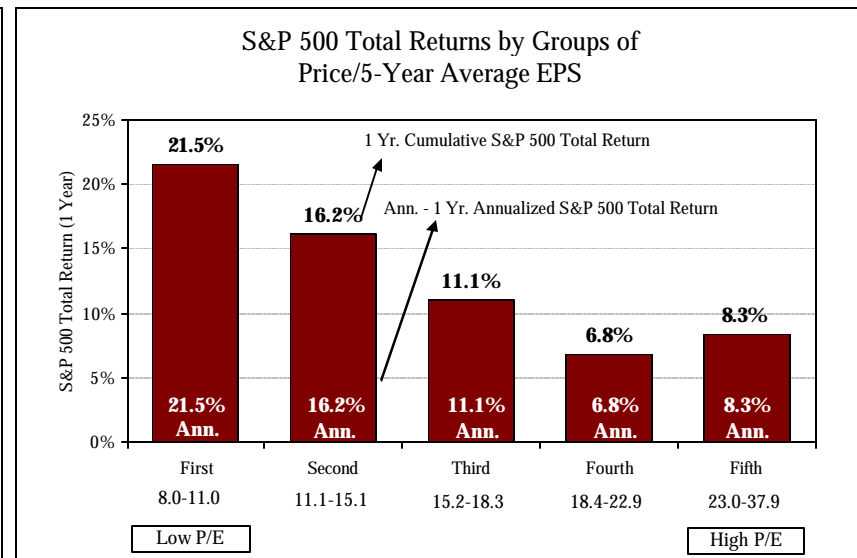


Chart 2: 1 Year Returns

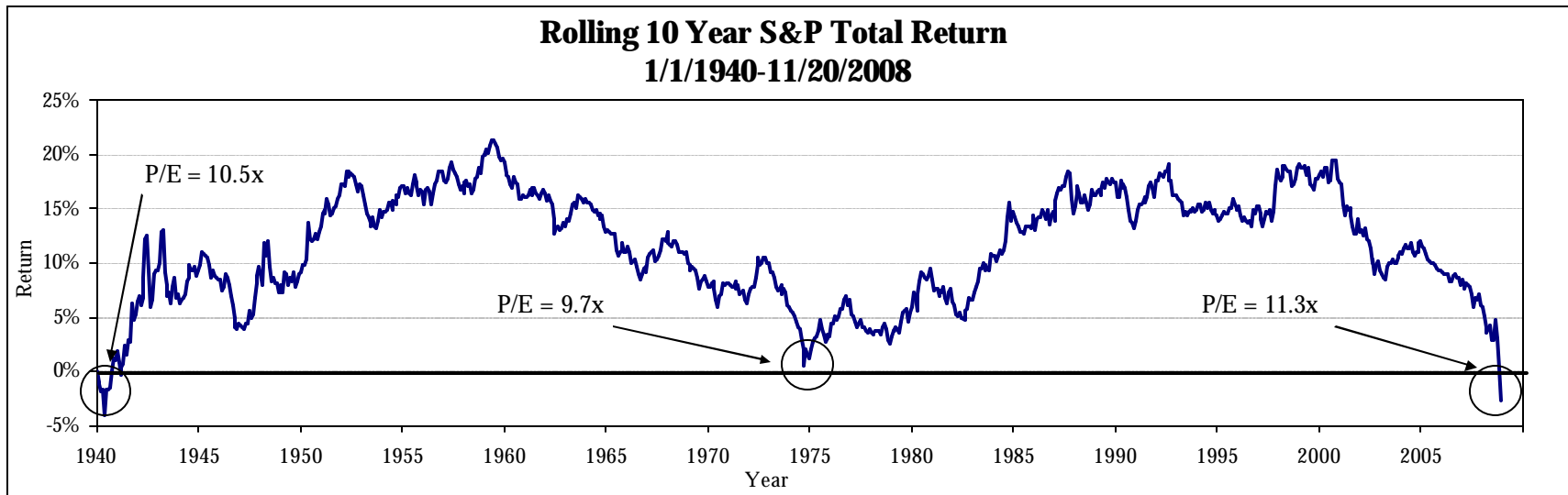


Source: Standard & Poors, EBS Analysis; Past performance is not indicative of future results.

Investment Performance after Poor U.S. Stock Market Returns over 10-Year Periods

While 2008 clearly has not been a good year for the stock market, it is even more frustrating to note that the U.S. stock market has not produced a positive return at all over the past ten years, let alone the 8-12% annual returns many expect from stocks over time. In recent days, the S&P 500 fell to an 11 year low. History once again demonstrates that long periods of stock market underperformance have been followed by long periods of outperformance. Chart 3, below, shows that when the market's 10-year track record was subpar, the returns going forward were impressive. **Each of these low points was associated with exceptionally attractive valuations, just as we see today.** The three major troughs in Chart 3 below—early-1940s, mid-1970s, and today—are characterized by P/Es registering on the left, or undervalued, side of Table 1 (page 2 of this report). Conversely, high points in Chart 3 below are characterized by P/Es on the right, or more expensive, side of Table 1. The toughest aspect of reaping potential rewards may be fighting the urge to sell in this market environment.

Chart 3



Source: Standard & Poors, EBS Analysis
Past performance is not indicative of future results.

Other Observations

- *S&P 500 Dividend Yield versus 10-Year U.S. Treasury Bond Yield*: For the first time since the early 1960s, **the dividend yield on the S&P 500 exceeds the interest rate on the 10-Year U.S. Treasury Bond**. This increase in the relative attractiveness of stock yields compared to U.S. Treasury yields is a positive for stocks.
- *Percent of S&P 500 stocks trading with a P/E below 10*: Chart 4, below, prepared by JP Morgan, indicates that **61% of the stocks in the S&P 500 traded below 10x earnings** at the end of October (over 300 of the 500 stocks comprising the S&P 500). With the continued decline in stock prices during November, the percent of stocks below 10x earnings has certainly risen further. The last time this percentage of stocks traded at such low levels was in 1982. To get an idea as to where the 1982 valuations stack up, refer to the 2 leftmost columns in Table 1 (82-1, 82-2 and 82-3). In the past, when stocks have traded at such cheap levels, it has proven to be an extraordinary time to own stocks.

Chart 4

Figure 5: On 10/27, 61% of stocks in S&P 500 with LTM PE < 10x

Since 1973



Source: Datastream.

Source: JP Morgan "U.S. Equities Strategy"

Past performance is not indicative of future results.

- *Warren Buffett's advice:* Buffett rarely pens his thoughts on the outlook for stock returns. On occasions when he has, it has paid to take note. In each article, he indicates that he has no idea where the market is heading in the short run, but instead makes the case for likely returns over longer time horizons. Buffett's latest article is bullish, "Buy American. I Am." Refer to the summary below:

<u>Article Date</u>	<u>Source</u>	<u>Viewpoint</u>	<u>Cumulative Return (Annualized)^(a)</u>			<u>Table 1</u>	
			<u>3 yrs (%)</u>	<u>5 yrs (%)</u>	<u>10 yrs (%)</u>	<u>Qtr [Col](c)</u>	
November 1974	Forbes	Bullish	42 (12.4)	74 (11.8)	266 (13.9)	74-4	[10.5]
August 1979	Forbes	Bullish	28 (8.7)	96 (14.4)	397 (17.4)	79-3	[10.5]
November 1999	Fortune	Bearish	-30 (-11.1)	-9 (-1.8)	-37 (-5.0) ^(b)	99-4	[40.0]
October 2008	NY Times	Bullish	??	??	??	Now	[11.5]

Footnote: (a) Return is the cumulative (annualized) total return for the S&P 500

(b) Nine years ending November 2008

(c) The color coded year and quarter blocks are taken from Table 1 on page 2. The number in brackets, right of each block, is the P/E ratio column.

Conclusion

This year has been a very trying time for investors. For that matter, so has the past decade. Panicked investors are exiting the market in droves. Even Berkshire Hathaway, the company run by Warren Buffett and built to withstand disasters, has fallen more than fifty percent from its high.

Today, the stream of negative economic and financial news seems endless. Stock price volatility has reached extraordinarily high levels. Measures of bearish investor sentiment have hit record levels, while consumer confidence indices have fallen to all-time lows. Hordes of investors have fled stocks for the safety of money market funds and treasuries because of the uncertainties that exist today.

The other side of this picture is what we described in this report: Stock prices have become extremely cheap compared to historical levels. We have no way of knowing for sure whether current stock prices fully reflect the negative economic news that is certainly coming. Given the severity of the decline, we suspect they do. We feel strongly that stocks should provide good returns and likely above average returns over the next 5-10 years.

At such times, it is worth reflecting on a point made by both Ben Graham and Warren Buffett. They note that great investment opportunities don't occur in the midst of a "cheery consensus", but rather when uncertainties and fears are running high.

Appendix A

S&P 500 - Summary Data Table

Groups based on Price/5-Year Average earnings-per-share

Annualized S&P 500 Total Return:

<u>Group</u>	<u>P/E Range</u>	<u>1 Yr</u>	<u>2 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
First	8.0 - 11.0	21.5%	20.6%	19.8%	19.1%	16.4%
Second	11.0 - 15.1	16.2%	14.6%	14.2%	13.1%	14.7%
Third	15.1 - 18.3	11.1%	10.2%	10.5%	11.1%	13.4%
Fourth	18.3 - 22.9	6.8%	6.6%	7.8%	9.0%	9.6%
Fifth	22.9 - 37.9	8.3%	9.5%	9.4%	8.6%	7.6%

Cumulative S&P 500 Total Return:

<u>Group</u>	<u>P/E Range</u>	<u>1 Yr</u>	<u>2 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
First	8.0 - 11.0	22%	46%	72%	140%	358%
Second	11.0 - 15.1	16%	31%	49%	85%	293%
Third	15.1 - 18.3	11%	21%	35%	69%	251%
Fourth	18.3 - 22.9	7%	14%	25%	54%	149%
Fifth	22.9 - 37.9	8%	20%	31%	51%	109%

The level of the S&P 500 P/E has consistently differentiated high return and low return environments over all time frames. The degree of differentiation over all time frames is significant and becomes stronger as the time horizon lengthens.

Source: Standard & Poors and Ibbotson & Associates

Past performance is not indicative of future results.

Market and economic data has been obtained from third party sources. This data, while believed to be reliable, has not been independently verified by EBS.