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INVESTER INSIGHTS - FOURTH QUARTER 2017

High P/Es and Low Interest Rates
A Dream Come True if Your Goal is to Live in Interesting Times

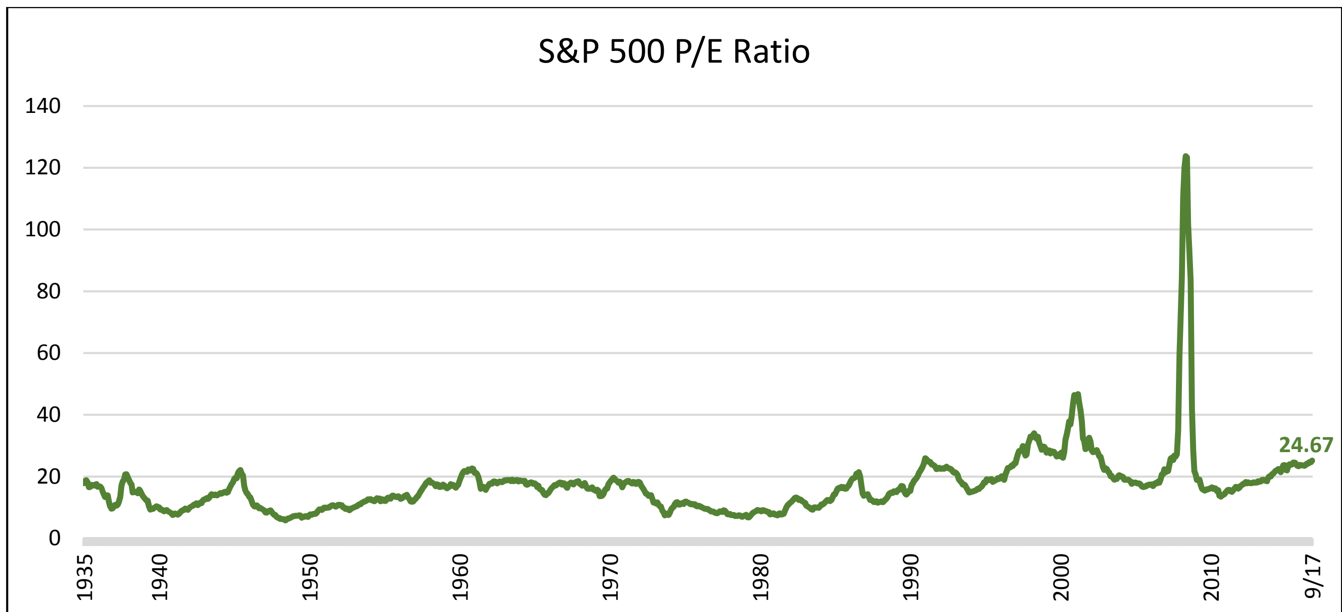
The stock market is high and the bond market is very high; so, if you were interested in seeing how you could maneuver difficult times, your dream has come true. We are not interested in that, we are interested in developing thoughtful and timely investment solutions that will solve the investment needs of your clients. We would be much happier living in a high interest rate, low P/E environment. Why? Because it is easier to achieve return and thus solve the investment needs and goals of your clients. But we do not get to live out our fantasies nor do we get to invest only during good times: we must make recommendations based on reality and today our reality is far from perfect. So, let's look at the stock market and the bond market and see what we find.

The Stock Market

If you looked at the P/E of the market today and compared that to the P/E of the stock market monthly going back to 1936, you would find some interesting observations.

- The highest P/E occurred just before the stock market decline of 2008.
- The second highest P/E occurred just before the stock market decline of 2000-2001-2002.
- During both periods, the stock market fell 50% in round numbers following these peaks.
- The lowest P/Es occurred in 1937, 1941, 1948, 1974, 1979 and 1982.
- These periods were followed by very significant increases in stock values.

Chart 1



Source: S&P Compustat

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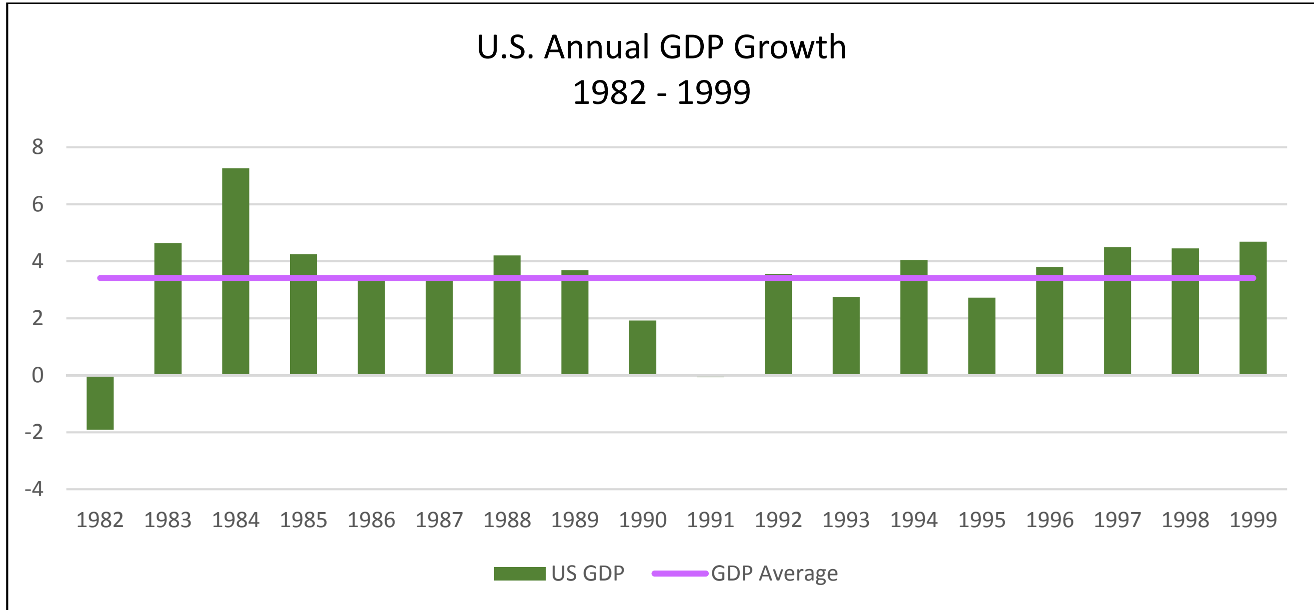
Today the stock market is too close to the P/E highs of 2007 and 1999. It is lower but right up there with the other periods when valuations were extremely high. So perhaps we have no worries, perhaps stock prices will continue to rise until they reach the ridiculous prices of 2007 and 1999. Perhaps, but this is the worst advice that we have ever written, despite us writing it sarcastically! The stock market is at best fully priced and likely overpriced, so be careful and study systems that worked in the extreme times of 2000-2002 and 2008.

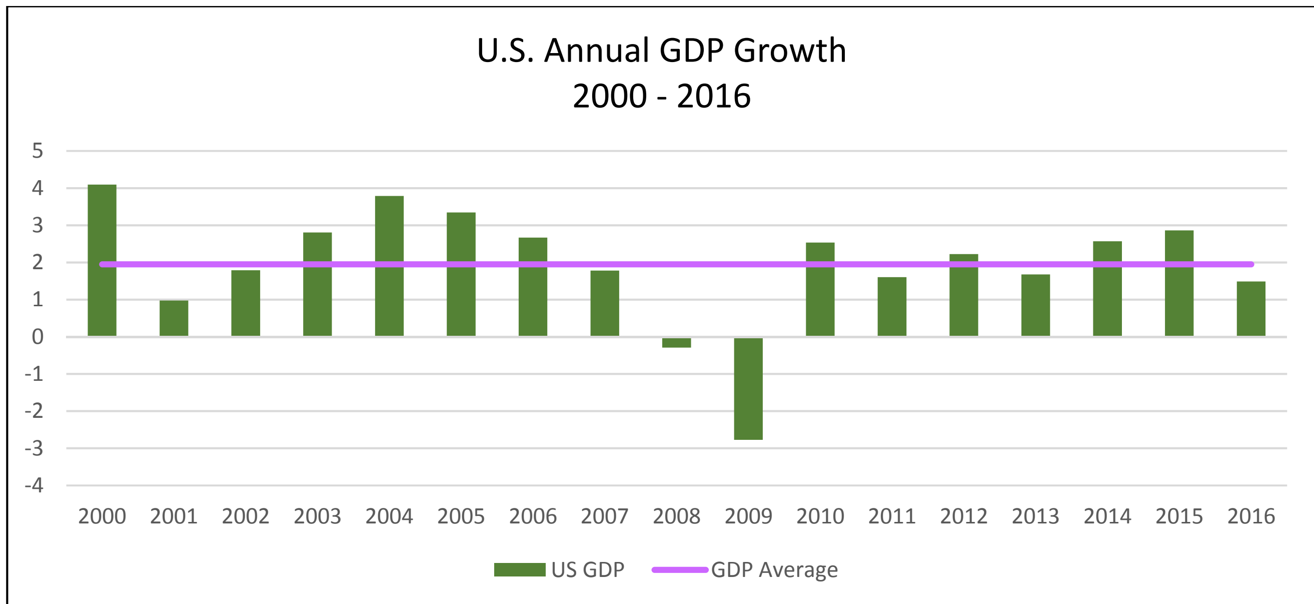
Index Returns v. Growing Dividends and GDP Growth

Chart 2



Source: Bureau of Economic Analysis

Chart 3



Source: Bureau of Economic Analysis

GDP growth in this country from 1982-1999 was just under 4%, while GDP growth from 2000-2016 was under 2%. Now it makes sense that we would expect higher returns in high GDP growth periods rather than low GDP growth periods, and that is what we got. The S&P 500 compounded at 18.5% from 1982-1999 and only 4.5% from 2000-2016. If you compare the S&P 500 Index with the S&P 500 reconfigured for contributions to the dividends of the index as Jeremy Seigel, you would find exactly what you expect. During the 1982-1999 periods the S&P 500 outperformed the dividend strategy, 18.5% for the index and 17.6% for the dividend strategy. The 2000-2016 saw a reverse of that, with the S&P 500 compounding at 4.5% while the dividend strategy compounded at 8.1%.

Chart 4

	1982 - 1999 P/E Expansion			**2000 - 2016** P/E Contraction		
	Total Return	Price Return	Dividend Return	Total Return	Price Return	Dividend Return
S&P 500	18.5	14.8	3.7	4.5	2.5	2.0
<u>Top Quintile</u>						
Dividends	17.6			8.1		

Source: Robert Schiller ,Stock Market Data Used in Irrational Exuberance Princeton University Press, 2000, 2005, updated.
http://www.econ.yale.edu/~shiller/data/ie_data.xls

So, the lesson from those periods is simple, do not take risk in high P/E periods. Today we are in a very high P/E period. Now we use growing dividends as our equity strategy. We believe it is a better idea because as we continue to live in a low GDP growth environment, the cash flow from your dividends will contribute more to your total return than appreciation, just as it has since 1999. We have been using this high and growing dividend strategy for almost 18 years. We have gotten 90% of the up capture and 75% of the down capture of the market, reduced volatility by 10% and gotten an 8.4% return when the market has gotten 4.9%.

There is one more data point that we think is worth noting. Jeremy Seigel did not break out his total returns into dividends and appreciation. You can see in Chart 4 that the 4.5% return of the S&P 500 breaks out as follows: 2.5% came from appreciation and 2.0% came from dividends. It would not surprise us if the dividend strategy got a similar level of appreciation, 2.5%, but much higher dividends.

While we think the market is high, who knows how long it will go on. So, we stay fully invested in equities, but we do not depend on appreciation as the largest component of return. We depend on dividends. Our portfolios today have 3.5% yield and should grow dividends at 8%. That is what makes us comfortable. If you look at the last two declines in the stock market, 2000-2002 and 2008, when the stock market decline in round numbers at 50%, we saw dramatically different results from our strategy. In the first period, we were positive because there was a shift from tech stocks to value stocks. In the second period, we declined less than the market but still a significant decline because all correlations went to one and everything declined. What will the next decline hold? Will it be more like 2000-2002 or 2008? Nobody knows, and market timing is fools play. The most likely occurrence is that the next market decline will not be like either of those declines, it will have a

story of its own. But we like our position. Everyone is talking about the upcoming decline, the 2018 correction. You have read all the stories of no correction since the bottom in 2009, so how long can this continue. Well the answer is likely longer than you think, so you need an equity strategy that will protect you if we have a decline, yet will give you reasonable returns if we do not have a decline. Growing dividends will do that for you. And that 2018 correction, it could take place in 2023!

Low Interest Rate Investing

By any standard, interest rates are low, very low. The last time we saw rates this low was the decade of the 1940s when the total return of the U.S. 10 Year Treasury was 2.5% annualized. Today we are seeing the exact same phenomenon. The annualized return of the Barclays U.S. Aggregate Bond Index from October 1, 2011 through September 30, 2017 was 2.65%, eerily like the 1940s. So here is the problem you have with those returns, you cannot solve your clients' investment needs and goals with a return of 2.65%. We know you know this is the case, so our belief is you cannot be as dependent on fixed income as you have historically. You must have less fixed income in your client portfolios. Just in case you are wondering if things improved after the 1940s, the return of the 10 Year U.S. Treasury in the decade of the 1950s when rates rose was 0.8% per year. This makes the 2.5% return of the 1940s look like the good times. Neither are the good times, and that is why you cannot be as dependent on fixed income.

Alternative Investments

Our answer to this dilemma is to add Alternatives to your overall allocation. We have been using these types of portfolios for almost 18 years and we have achieved a 7% annualized return with a 7.5% standard deviation. Most of that period saw us using Windward which became Windhaven. Today we still use Windhaven as well as 3EDGE, which was founded by Steve Cucchiaro after he left Windhaven. We have written a paper on how to add this asset class to a 60/40 stock/bond portfolio which we would be happy to send to you. Drop us a line and we will get it to you.

Our Answer

So, what is our answer to investing in these interesting times? We have two pieces of advice; stay with a thoughtful equity strategy that will do well in a high P/E environment and use our Alternative portfolio. Every client needs a slice of our Alternatives portfolio as a part of their allocation.

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