PrudentBear.com
The One-Stop Shop for the Bear Case

Guest Commentary: David Moore

August 5, 2002

Good news or bad?

David Moore is an analyst with Castle Creek Capital, a merchant/investment banking firm specializing in the financial services sector.

Fundamentals support a 700 target on the S&P

Clearly, most equity investors are currently experiencing a level of pain for which they never prepared themselves. The good news – or bad news, depending on your vantage point – is that, amongst all the failed “bottom calling” of recent months, a 700 level on the S&P 500 (my proxy for “the market”) appears to be supported by the index’s underlying fundamentals. In fact, in recent weeks, Jeremy Grantham (in *Barron’s),* John Vail (on this website), and others have established “fair value” estimates of 700 for the S&P. Importantly – and hopefully obviously – this is *not* meant to suggest that the market will necessarily stop falling once it hits the 700 level; rather, it is meant to suggest that intrinsic value for the S&P appears to be in the neighborhood of 700, the reasoning for which follows.

In a piece titled “On the Nature of Long Term Returns from Holding Stocks” that was published on this site on June 4, 2001 (the S&P closed at 1267 that day), I suggested that the S&P was considerably overvalued based on “common sense insights into [then] current valuations and future return expectations that are somewhat immutable.” In that piece I provided a simple framework for estimating future returns from holding stocks as follows.

Returns for passive holders of the S&P 500 over the next ten years will principally be a function of four variables: (1) the index’s beginning P/E ratio, (2) the index’s beginning dividend yield, (3) earnings growth over the 10 year period, and (4) the index’s ending P/E ratio. Thus, to use a specific example, if we take the current P/E ratio on the S&P (15.9x on the current 2002 operating earnings estimate of $50), the S&P’s current dividend yield of 1.9%, assume 5.5% annual earnings growth (the long-term average for the S&P) over the next decade, and assume that the market in 2012 will be trading at 17x earnings, passive holders of the market will achieve an annualized return of approximately 7.5%. The math is as follows: 5.5% (earnings growth) + 1.9% (dividend yield) + 0.1% (the annualized effect of the S&P’s P/E ratio increasing from 15.9x to 17x over the 10 year period) = 7.5%. Although this return is an approximation due to dividend reinvestment issues, it is a very close approximation. Moreover, the relationship between the variables as stated above is axiomatic – there’s no escaping this equation when estimating future returns.

So, the question that remains is: What risk premium should investors require over risk-free securities in order to induce them to hold equities? Much has been written about the equity risk premium, especially during the recent “bubble years.” In fact, in May, Prudent Bear’s own Chad Hudson penned a piece titled “Is there Risk to the Risk Premium?” in which he summarized an outstanding article by Peter Bernstein and Robert Arnott called “What Risk Premium is Normal?” that appeared in a recent issue of *Financial Analysts Journal.* In summary, Mssrs. Bernstein and Arnott conclude that the 5% risk premium that equity investors subsequently realized between

1926 and 2000 was not a reasonable expectation at the initial investment period (1926) and was, in fact, the result of several unexpected one-time adjustments to inflation, interest rates and valuations. After twenty pages of fairly rigorous analysis, the authors further conclude that the “proper” risk equity risk premium is roughly 2.5%. Thus, applying a 2.5% risk premium to the current 5.5% yield on 30-year Treasuries leaves us with an 8% “required” rate of return on stocks.

So, how are equity investors going to capture that magical 8%? Well, if the S&P trades down to 700 and earnings and dividend expectations remain unchanged, we’ll have a P/E of 14x and a 2.2% dividend yield. If earnings (and dividends, by implication) average 5.5% annual growth over the following ten years and the market’s P/E expands to 14.5x (the long-run average for the S&P) by 2012, then passive holders of the market will achieve an annualized return of approximately 8.1% over the period (a bit more than 8%, but close enough to our goal for government work). The math is as follows: 5.5% (earnings growth) + 2.2% (dividend yield) + 0.4% (the annualized effect of the S&P’s P/E ratio increasing from 14x to 14.5x over the 10 year period) = 8.1%.

Thus, in the final analysis, it appears that the S&P is hurtling through investment space toward the destination of fair value, which given current facts, appears to be approximately 700. Having said that, during which previous bear markets did the S&P’s drop merely stop at fair value? Answer: none of them. And therein lies the real problem going forward.

Opinions expressed are not necessarily those of David W. Tice & Associates, LLC. The opinions are subject to change, are not guaranteed and should not be considered recommendations to buy or sell any security.

Copyright David W. Tice & Associates, LLC. 2005 Privacy Policy | Terms & Conditions