# INVESTMENT STRATEGY UPDATE

September 25, 2003

## DIVIDENDS MATTER

It's amazing. Barely six months have passed since our *Investment Strategy Update,* "What a Difference Three Years Make" was written. Pessimism was rampant back then. Investors' portfolios had been devastated by one of the worst bear markets in history. But as a result, stock market valuations had fallen to near-normal levels, and there was a huge amount of buying power on the sidelines awaiting even the slightest sign of improvement. We concluded that a bottom might be near.

The investment environment has changed greatly since then. So much so, that we could have called this *Investment Strategy Update* "What a Difference Six Months Make." Consider the shift in sentiment over just the last two quarters. Six months ago, a growing number of investors were questioning whether stocks were still appropriate holdings in their portfolios, given their significantly lowered investment goals and the obvious risks associated with equities. Bonds seemed the better answer, they thought. But now, a lot of those same investors are getting back in the game, once again buying technology stocks and aggressive equity mutual funds. We have even begun to receive questions from some of our clients, asking whether the guidelines they provided to us might be too conservative. Clearly, the juices are flowing again. The bear market lows are behind us, and whether this past March was the actual bottom or simply a test of the previous October's lows is matter for the academicians to decide. The important questions are: What comes next? How should our clients' portfolios be structured?

We have been surprised at how quickly speculation has reemerged. Year-to-date, the best performing stocks have been those in the smallest capitalization, highest valuation categories. And once again, technology stocks are leading the way. However, in contrast to the great technology bubble, this year's market leaders are primarily companies with actual earnings.

But while the prospect of substantial price appreciation seems the primary investor motivation today, our expectation is for relatively modest stock market returns going forward. Accordingly, we believe that dividend yield will provide an important part of investment return. Even before the president's new tax package, we were suggesting that a focus on higher-quality dividend-paying stocks during coming years would likely provide very competitive returns with relatively low volatility. But so far in this post-bubble/post-bear market stock rally, dividends have been of little importance.

## Near-Term Outlook

There are numerous reasons for the stock market's stellar performance since the bottom. A deflation fighting Federal Reserve Board has injected substantial liquidity into the system and brought short-term interest rates down to levels not seen in nearly half a century. In addition, the recently enacted tax bill is strongly pro-growth and pro-stock market. Furthermore, there is still a mountain of cash (potential buying power) on the sidelines, earning very little. And at least for now, there is a distinct lack of attractive non-stock market investment alternatives.

Then again, the stock market's very strong performance this year may simply be typical of what happens following bear markets. A special research study, recently published by the Leuthold Group, examines the 21 bear markets that have occurred during the last century and the subsequent stock market recoveries. As shown in the summary results below, the stock market rose a median 38% during the first twelve months following bear market bottoms. Stocks rose an additional 10%, on average, during the second twelve-month period following the lows, with only 3 of the 21 markets studied showing a negative second-year result. So far, the current market rise has rather closely mirrored the typical bear market recovery.

**100 Years Of Bear Market Recoveries**

**(DJIA: 1900-1926; S&P 500 1926 to Present )**

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| Stock Market Peaks & Troughs | | | | Bear Market Statistics | | | Performance From Bear Market Low | | |
|---|---|---|---|---|---|---|---|---|---|
| Date Of Market Peak | Market Peak Level | Market Trough Level | | Date Of Market Trough | Peak To Trough Performance | Duration Of Bear Market | Performance 1 Year Later | Cumulative Perf. 2 Years Later | Cumulative Perf. 3 Years Later |
| ********** | ********** | ********** | | ********** | ********** | ********** | ********** | ********** | ********** |
| Jun-17-1901 | 57.33 | 30.88 | 1 | Nov-09-1903 | -46% | 29 Months | 59% | 93% | 122% |
| Jan-19-1906 | 75.45 | 38.83 | 2 | Nov-15-1907 | -49% | 22 Months | 66% | 87% | 60% ** |
| Nov-19-1909 | 73.64 | 53.43 | 3 | Sep-25-1911 | -27% | 22 Months | 28% | 13% * | -2% ** |
| Sep-30-1912 | 68.97 | 52.32 | 4 | Jul-30-1914 | -24% | 22 Months | 44% | 70% | 76% |
| Nov-18-1916 | 110.15 | 65.95 | 5 | Dec-19-1917 | -40% | 13 Months | 25% | 59% | 5% ** |
| Nov-03-1919 | 119.62 | 63.90 | 6 | Aug-24-1921 | -47% | 21.5 Months | 56% | 44% * | 62% |
| Sep-07-1929 | 31.92 | 4.41 | 7 | Jul-08-1932 | -86% | 34 Months | 172% | 124% * | 141% |
| Jul-18-1933 | 12.20 | 8.06 | 8 | Mar-14-1935 | -34% | 20 Months | 81% | 127% | 34% ** |
| Mar-10-1937 | 18.68 | 8.50 | 9 | Mar-31-1938 | -54% | 12.5 Months | 29% | 44% | 17% ** |
| Nov-09-1938 | 13.79 | 7.47 | 10 | Apr-28-1942 | -46% | 41.5 Months | 54% | 59% | 98% |
| May-29-1946 | 19.25 | 13.55 | 11 | Jun-13-1949 | -30% | 36.5 Months | 42% | 59% | 80% |
| Aug-02-1956 | 49.75 | 38.98 | 12 | Oct-22-1957 | -22% | 14.5 Months | 31% | 44% | 37% ** |
| Nov-12-1961 | 72.64 | 52.32 | 13 | Jun-26-1962 | -28% | 6.5 Months | 33% | 56% | 59% |
| Feb-09-1966 | 94.06 | 73.20 | 14 | Oct-07-1966 | -22% | 8 Months | 33% | 42% | 27% ** |
| Nov-29-1968 | 108.37 | 69.29 | 15 | May-26-1970 | -36% | 18 Months | 44% | 60% | 56% ** |
| Jan-11-1973 | 120.24 | 62.28 | 16 | Oct-03-1974 | -48% | 20.5 Months | 38% | 67% | 55% ** |
| Nov-21-1976 | 107.83 | 86.90 | 17 | Mar-06-1978 | -19% | 17.5 Months | 13% | 25% | 49% |
| Nov-28-1980 | 140.52 | 102.42 | 18 | Aug-12-1982 | -27% | 20.5 Months | 58% | 62% | 83% |
| Aug-25-1987 | 336.77 | 223.92 | 19 | Dec-04-1987 | -34% | 3.5 Months | 21% | 57% | 46% ** |
| Jul-16-1990 | 368.95 | 295.46 | 20 | Oct-11-1990 | -20% | 3 Months | 29% | 36% | 56% |
| Jul-17-1998 | 1186.75 | 957.28 | 21 | Aug-31-1998 | -19% | 1.5 Months | 38% | 59% | 18% ** |
| Mar-24-2000 | 1527.46 | 776.76 | 22 | Oct-09-2002 | -49% | 30.5 Months | ??? | ??? | ??? |
| | | | | **Average** | **-37%** | **19 Months** | **47%** | **61%** | **56%** |
| | | | | **Median** | **-34%** | **20 Months** | **38%** | **59%** | **56%** |

*** Notes Loss In Second Year of Recovery**

**** Notes Loss In Third Year of Recovery**

Source: The Leuthold Group

It is said that "the stock market climbs a wall of worry." And certainly, there has been a lot to worry about. Unemployment, an overly indebted consumer, deflation, inflation, budget deficits, current account deficits, war, and terrorism comprise only a partial list. But it is the sidelined cash that concerned investors hold back, awaiting better news, that provides the fuel for a continuing advance. As stocks have risen, confidence has begun to grow again, resulting in an increasing rate of inflows into equity mutual funds. Given how far we have come, it would not be surprising to see stocks enter an interim corrective phase. But to us, this market continues to have all the earmarkings of one that is headed higher.

**Beyond The Recovery – In Favor of Dividends**

So what does all this do to our expectation of modest returns going forward? Very little, actually. It's a question of time horizon. Our outlook for the next several years is for a stock market that behaves much like it did during the second half of the 1970s. The early 1970s had also experienced a stock market bubble, with a small group of quality growth stocks, called the Nifty Fifty, rising to extreme valuations. Inevitably the bubble burst, resulting in a very tough bear market that lasted through most of 1973 and 1974. But during the twelve-month period following the bottom, the S&P rose 38%, precisely the median first-year rise described earlier. The next twelve-month period was very strong as well, stronger than we anticipate for the second year of the current market rise, mostly because stock market valuations are already relatively high. Then followed a several-year period of cyclical bull and bear markets, with little overall net progress.

That is the type of stock market environment we foresee following the current bull phase – several years of cyclical up and down moves, resulting in, perhaps, 5 to 8% average annual returns. Earnings growth and dividend yield are likely to account for the major portion of those returns. Corporate earnings grow in line with nominal GDP over time, roughly 6% per year, and dividend yields are still quite low, historically. Change in valuation, the third broad component of stock market return, may actually be somewhat negative over the period. Stocks are not particularly cheap at this time, and we believe investors will gradually lower their higher-than-average equities allocations to a more historically normal level.

And what about the technology stocks? Interestingly, following large speculative bubbles, it is not unusual for the former bull market leaders to also lead the first leg of the subsequent recovery. But after that, the asset previously most favored has tended to underperform for the next several years. For example, it took almost twelve years for the majority of the Nifty Fifty stocks to reattain their previous highs. And for the most part, the Nifty Fifty were quality growth stocks. Technology stocks, by contrast, are and always will be highly cyclical by nature. We think that the current tech rally has further to go, but not too much further. Technology valuations are already pricing in a rather substantial amount of operating improvement.

## Chevron Texaco – An Example

It has not been our practice to mention individual stocks in these quarterly updates. But this time, it seems worthwhile to present a specific example of our thinking. Consider the shares of Chevron Texaco Corporation (CVX). As an individual stock, CVX is neither cheap nor expensive. Rather, its shares appear to be appropriately valued. As we have often mentioned, stock prices appreciate in line with earnings growth over time. And analysts expect Chevron Texaco to grow its earnings at a 7% annual rate over the next several years. In addition, CVX shareholders receive a $2.92 annual dividend which, by the way, has been increased each and every year for the last sixteen years. At today's prices, the current dividend equates to a 4% yield. So, assuming its current valuation persists, CVX stock should provide investors with an 11% total return going forward.

Therefore, on the one hand, we have a stock market from which we are expecting modest single-digit returns, in an environment in which cash, bonds, and other non-stock market alternatives seem relatively unattractive. On the other hand, we have the relatively conservative, perhaps even somewhat stodgy, Chevron Texaco stock that should provide investors with a total return of slightly more than 10% over time, of which close to half comes by way of a tax-advantaged dividend yield. It seems to us that with a portfolio of Chevron Texaco-type stocks, investors are likely to earn above-average stock market returns with less-than-average volatility.

The bottom line is that in the environment we foresee, dividends are likely to become a much more important part of investor return. And with the new tax law placing a 15% maximum tax on dividend income, there is now an even greater incentive to favor dividend yield. But so far, in this post-bear market period, investors have been focused on their expectations of large capital gains going forward. Dividend yield has been of little importance. Nonetheless, the pace of the current stock market advance seems unlikely to persist for very much longer. With lower returns will come lower expectations and a refocus on the importance of fundamental value and especially dividend yield. Dividends do matter.

*Previous Investment Strategy Updates are available online – www.btrcap.com*



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