The Worst of Times

I regret sounding the inaugural edition of the Alpine Investment Management newsletter on a sour note. However, if one is a buyer of stocks, it is indeed the worst of times. Equally true, if you are a seller of stocks, it is the best of times. Yet, since we have a lot more fun buying than selling, and because we are in the business of employing capital, we feel obligated to engage in a little old fashioned bellyaching.

This stock market stinks! (Remember, we're buyers). Practically every equity security in the marketplace is over-priced. It is like going to the mall and finding everything marked up 100%. However, in the mall you would know everything has not increased *in value* by 100%. In the stock market, things are more mysterious. The following analysis is meant to shed a little light on the mystery of past and future stock returns (our sole purpose being to recruit more members into the "worst of times" camp).

From the bottom – this long period of great returns, which we have come to know and love, began in 1975. That's old in stock market time. The average person born after 1920 doesn't know what a bear market *really* feels like, assuming bear markets only hit home after age 55. That is when most of a person's savings have finally compounded into the real money which will fund their retirement.

While we are not in the business of predicting bear markets (it hasn't been very profitable), we are in the business of protecting our clients' capital. **The figures below support our position, for the record, that stock market returns are going to be very low in the future.** We only wish we knew *when* this period was going to begin. But we don't. Nor do we know *how*. It may come in one fell swoop or slowly over a decade or two.

What we do know is just how low low may be. Our first table includes in bold S&P 500 total returns past and future. More importantly, the fundamental sources of these returns are also listed. You can more or less add these sources to get the total.

	1975-1999	2000-20xx
S&P 500 Annual Total Return:	**17.2%**	**6.2%**
- from dividends:	5.3%	1.2%
- from earnings growth less inflation:	2.0%	2.0%
- from inflation:	4.8%	3.0%
- from P/E ratio change:	5.4% (7.7 to 28.9)	0.0%

So how good are our numbers for the future? The dividend yield is an indisputable fact. The return from inflation doesn't matter; we only care about returns after inflation. That leaves the return from earnings

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growth less inflation and the return from the future P/E ratio change. Both are subject to guesstimation. However, as the figures below relate, the return from earnings growth less inflation has been remarkably consistent:

	Earnings Growth Less Inflation
1926-1999	1.9%
1950-1999	2.1%
1980-1999	1.9%

Earnings grow less inflation could well vary from 2% in the future. However, predicting it will be higher than 5% or lower than 0% would be highly suspect. Regarding the return from the P/E ratio change, we assume it will remain where it is today. We do this to foil the optimists. While the P/E could very well move higher in the short run, predicting it will stay around 30 indefinitely gives new meaning to the word optimism.

So let's say this is all more or less on target. What is one to do? Our strategy is to remain highly conservative when allocating between stocks and bonds and to be highly selective regarding the stocks we are buying. Not all stocks will return 6% in the future.

And of course, most of us have not suddenly become buyers. We were buyers when prices were reasonable. To us, it has been the best of times. Or so it seems. In the stock market, the best is usually better than it should be, and the worst is usually worse than it should be. And in the end, there is a balance between the two.

Nick Tompras
February 2000

As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

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