



Commentary

Back to Normalcy

Warren Buffet said, 'markets are a voting machine in the short-run and a weighing machine in the long-run'. Markets are generally rational and trade like a weighing machine. For the last 20 years the S&P has had a median P/E of 15 x forward earnings. During the 1991 recession, panicked voters took control of the market and reduced the P/E to 12 x earnings. Conversely, in the internet bubble ebullient voters took the P/E to 24 x.

With the deflating of the internet bubble, the weighing machine controlled the market from 2002 to 2007. The S&P 500 traded at a consistent 15 multiple. Then in 2008 voters left the polls in mass like passengers from a sinking ship. By March of 2009 the weighing machine seemed broken as the P/E was under 10 x on very depressed earnings. Most believed the scales were permanently broken.

But in March of 2009 selective voters came back to the polls. They were not the stampede of votes that exited, but were enough to influence the out come and drove prices higher. Pundits in the media cried 'double dip' as the news on Main Street is still bleak. Most professional politicians (money managers) also were skeptical and did not believe the results. Amazingly, the weighing machine tells us the recent voters were correct in pushing the S&P 500 to the current level. The S&P currently trades at the normal 15 multiple. The exact multiple of the market before voters took control. Once again Mr. Buffet is right.

So now what? The answer is determined by the direction of earnings. Earnings for the S&P peaked at \$103 in December 2007. Apply the 15 multiple and you get the 1570 high of October 2007. Earning then collapsed to \$63 in April of 2009. Apply the 10 multiple voters ascribed and you get the 660 low for the S&P in March 2009. Since then, both the forward earnings and the multiple voters are willing to pay for those earnings have been rising. Currently earnings are \$80 and voters are willing to pay the normal 15 multiple which equals the current 1180 valuation of the S&P 500.

To determine where those earnings might go in the next few years let's look to the last two economic recoveries. In the recoveries of 1994 -1999 and 2003 - 2007 earnings grew about +100% from the bottom of the cycle to the top of the cycle. Given that earnings bottomed around \$63 in April 2009, the peak earnings number for this cycle might well be around \$120. Using the normalized 15 multiple that would prognosticate a market top of 1,800 for the S&P 500.

That 50% appreciation from the current 1180 would most like take place over the next 2 to 4 years as earnings rise to these peak levels. If that takes place over 4 years it would result in an 11% CAGR. This is a solid rate of return. However, investing in earnings momentum stocks which is the core discipline of the WAM Enhanced Growth Fund should produce higher returns as earnings momentum stocks generally have higher earnings acceleration and therefore higher returns in bull markets.

At the risk of sounding like a broken record 'increase your clients waiting in stocks'. Most people are still nervous and are not heavily invested in stocks. They are waiting for a pull back to consider entering. More than half of the returns of this bull cycle have likely occurred. Every day you wait to invest, the expected rate of return declines. Earnings momentum stocks are the place to invest, as these stocks offer the greatest price appreciation from both rapidly increasing earnings and P/E multiple expansions.

During the last two years when emotional voters were in control of the market the Enhanced Growth Fund was not 100% invested in the earnings momentum models (see September 2009 commentary 'Geese in the Engines'). Given that the market is now controlled by the weighing machine we are following our models 100%. Excess return vs. the market will be created by owning those stocks that deliver positive earnings surprises. Also, given WAM's goal of complete transparency, the monthly commentary will now include full disclosure of both the Income and Growth Fund portfolios.

-Derek Webb

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