

Where the Values Are

In selecting appropriate investments that we believe will perform well, we habitually take a reality check on the specific security – stock, bond, or what have you. As we look through the range of available options today, we see a situation that we first mentioned to our clients in the second quarter. Today there is an apparent relative mispricing between stocks of high-quality companies and bonds, which seems like an opportunity for long-term investors.

Over the course of this year, interest rates have dropped precipitously. Below is a chart showing the interest rates on US Treasury securities of varying maturities:

Treasury Bonds' Interest Rates

<u>Term</u>	<u>October '10</u>	<u>April '10</u>
1 Year	.23%	.47%
5 Year	1.1	2.6
10 Year	2.4	3.9
30 Year	3.8	4.8

Source: Baseline

The first thing to note is the generally low level of rates. Five years ago, one could find yields 2-3 *times* present yields available at a given maturity. There is not much income to be gleaned from bonds today. In fact, their yields are the lowest in 57 years. The high current prices on bonds are really as extreme as the prices of stocks were in the wild technology bubble of 1999-2000 (when the S&P 500's P/E ratio reached a record 28, double the long-term average of 14).

Next, you'll note the drop in rates this year, with yields on shorter maturities falling in half and on longer maturities falling by a quarter or more. This drop has allowed bonds to appreciate in price, keeping pace with the appreciation in stocks.

Looking forward, the question we need to ask as investors is whether over a reasonable time horizon, the bonds we purchase today give us a fair return on our capital. For the sake of comparison, let's take a 10-year Treasury bond that yields 2.4%. If we put \$100,000 into one today, we can expect to receive \$2,400 in interest each year and our \$100,000 back at the end of 10 years. To simplify things, let's assume that we experience neither inflation nor deflation during that entire time (though a 10-year period without any inflation in the last 100 years was rare, indeed). Assuming no risk in our loan to the US Government, that means that our return is a simple 2.4% per year.

Now we'll look at a "risky" investment with that same \$100,000. To avoid preconceived notions about a particular company or business, we'll just call it Company A. Company A is in a fairly consistent business – it does have some exposure to the ups and downs in the economy, but not a lot. Its revenues tend to recur year after year. It has an exemplary credit rating with no net debt on its balance sheet, and excess cash equal to 15% of its stock price. It trades at a modest premium to the



market multiple. To be conservative, we'll assume that the company can grow its earnings by about 5% per year over the coming 10 years (we think it can grow faster than that). The stock pays a current dividend of 3.2%.

How do we think through the expected investment return? Given the great balance sheet and modest payout ratio, we are comfortable counting on the 3.2% yield for each of those 10 years. One could argue that Company A's balance sheet is sounder than the US Government's. Even assuming an increase in the tax rate for dividends starting next year, on an after-tax basis we are still capturing a better income than with the Treasury bond each year, by a few hundred dollars. Before taxes, we get \$800 more per year from "A," or an additional \$8,000 over the course of 10 years.

So what to do with that pesky risk in the stock market? Prices will certainly fluctuate. But over the long term (the only way money should be invested in the market in the first place), we can conservatively expect the company's valuation (as measured by its price-to-earnings ratio) to stay about the same as it is today. If that is so, and assuming 5% growth in cash profits (and, therefore, in the stock's price) over those 10 years, our \$100,000 will grow to \$163,000. Added to the extra income from dividends at the 3.2% rate, we end up \$71,000 ahead of where we would be with the Treasury bond. But it may not stop there. "A" has a 40-plus year history of raising its dividend. If it does so at the same rate that earnings grow, we will be even better off, to the tune of another \$9,219 of cumulative higher dividends - and we would be receiving \$5,084 per year in dividends by the time year 10 rolls around: 112% more income each year than from the bond.

But what if the stock market goes down? Of course it could - and it probably *will* at some point in the next 10 years. Assuming no net market decline by the end of the decade and no dividend increases on "A," as stated above we would be \$71,000 better off (71%!) over that term with Company A's stock. This gives us a significant margin of safety, meaning that the market for the stock could fall as much as 44% (from the \$163,000 value mentioned above) and *stay* down, and we would still be break-even versus the bonds. A 44% drop from today's prices would put the market below where it was at its worst in March 2009. It's important to note that Company A's stock didn't drop nearly as much as the market in 2008 and 2009. That was due to the high quality of its business and its strong balance sheet. We would expect the stock's and the company's performance to be similarly stalwart in another market plunge.

To push the analysis a bit further, what if there is a bout of inflation? The bond's coupon won't change. The purchasing power of both the \$2,400 per year in income and of the principal will erode. Company A's stock will behave differently. Historically dividends of higher quality companies, including A's, have risen faster than inflation, driven by the company's earnings, which tend to grow more rapidly during times of inflation. This should allow the stock's price - assuming a consistent price-to-earnings ratio - to appreciate even faster than our base case of no inflation. In an inflationary environment, the investment in Company A is likely to outperform the bond.

Finally, what should we expect if there is deflation? Well the coupon for the bond stays the same - but the interest that we receive can buy *more* goods or services as prices drop, so we are better off. The dividend for "A" is similarly affected; however, the company could cut the dividend in the face of deflation. As long as the dividend isn't cut by more than 4% per year for *all 10 years*, the income from "A" is still superior. As for the value of the stock, there is the cross-current of the growing business (5% per year) versus deflation. If deflation doesn't exceed that 5% annual growth, the



stock should at least tread water over the 10 years. In this scenario, the relative performance is not as clear cut. However, on balance, “A” is likely to give us a better long-term result.

One remaining question might be, “Sure, here’s one company that is attractive, but what about all the companies that we invest in?” Today, that is the exciting thing. We are seeing opportunities in not just one or two stocks, but rather in several handfuls of these sorts of strong companies. We are able to spread risk over a portfolio of stocks covering many sectors and industries and not simply make a bet on one or two companies.

This leads us to ask: Which is more attractive? The bond whose principal may erode significantly from inflation and that pays us a meager income in any case, or the “risky” equity that will pay us a higher, and rising income and is likely to appreciate over the same time horizon. With full recognition of the ups and downs we’ll see in stocks, we’ll take Company A. There is no doubt that there will be a time in the future when bonds once again will pay us a reasonable rate of return for owning them. And bonds, especially shorter-term ones, continue to have a role in portfolios both as a source of stability and as a place to keep funds that you expect will be needed over a shorter time-horizon. But as for longer-term investing, we see better opportunity in the equities of high quality companies exemplified by Company A.

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