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EDITORIAL COMMENTARY

The 11% Solution

Forecasting broad market earnings creates new problems for investors

By ADAM BARTH

EVERY BUSINESS DAY, INVESTORS ARE BOMBARDED with new economic data, macro and micro, all of which supposedly affect the value of U.S. stocks. While some investors may dismiss macroeconomic information such as quarterly gross domestic product, initial jobless claims and factory orders as irrelevant in the making of portfolio decisions, few probably would file this year's and next year's earnings estimates for the Dow Industrials or Standard & Poor's 500 under a "More Useless Information" heading.

But that's what they ought to do: Insights about individual firms are valuable; fixation on broad measures of current or future earnings isn't. Not because predicting corporate earnings is an impossible task, but because future long-term macro-earnings can be predicted with almost complete precision.

Examine the Dow's annual return on equity for each 20-year period since 1920 (that is, 1920 through 1939, 1921 through 1940, and so on): Average earnings as a function of book value barely varies in the slightest, and has remained basically immune to inflation, wars, massive changes in the tax code or any other external factor.

For the 34 consecutive 20-year stretches between 1934-1953 and 1967-1986, the return fell in an incredibly narrow range of 10.5% to 11.6% -- or an average of around 11%. Furthermore, the Dow's book-value growth rate has remained near its 4.8% historical average from 1920 to 2003 for every 20-year period on record.

A Simple Calculation

Finding the Dow's normalized earnings in any given year is as simple as multiplying 11% by the Dow's book value at the time. These earnings will grow at a little under 5% per year -- the Dow's steady and predictable 20-year book-value expansion rate.

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Although almost all analysts focus on the current or following year's earnings forecast in valuing stock indexes

such as the Dow, the approach is primitive and misleading. While earnings gyrate from year to year, the Dow's earnings over the coming 20 years or any 20 years is virtually preordained.

The popular notion that the long-term earnings growth rate is highly variable and affected by the daily news that speculators, economists and the media slavishly focus on is a great red herring.

The portfolio strategy of "relative value" is based on this red herring. The many purveyors of this strategy tout their "bargain" investments in companies trading at price-earnings ratios in excess of 20 and well above any asset conversion or private-market value.

Where is the margin of safety for these investments? According to these investment managers, it exists in how underpriced their investments are, relative to the market. While these managers claim to be "bottom-up" value investors, they actually have tied their fates to that of the broader market.

A major reason for these managers' decision to shadow an index is the belief that stocks' superior performance in the past proves that they have been mistakenly undervalued, and should now command a richer valuation. As a result, most money managers have rejected traditional equity-valuation standards as overly demanding, and have replaced them with newer measures.

A Peculiar Notion

The most popular and influential of these new approaches is the "Fed model," which holds that U.S. stocks' earnings yield should equal that of the federal government's 10-year bond.

This Fed model rests on the absurd proposition that corporations' equity -- their most junior and risky obligation -- should be equated with U.S. government debt. This approach is nonsensical, as it completely ignores companies' priority of obligations and posits that U.S. public corporations' equity cost of capital should be the same as the risk-free rate. The Fed model pretends that the cardinal risk-and-return principles of finance do not exist.

In the rush to create valuation models that justify current stock prices, investors and economists have missed the clear evidence that historical valuations are not only logical, but virtually necessary.

The 11% solution demonstrates why this is so. Of the Dow's 11% ROE, 5% has consistently been retained -- thus allowing the Dow's 5% earnings-growth rate. The remaining 6% has been free cash flow available for distribution to shareholders in the form of dividends and stock buybacks. As such, the Dow is a perpetuity that can be easily valued by dividing its current free cash flow (6% of current book value) by its expected rate of return minus its long-term growth rate (9% minus 5%).

With the Dow's current book value a little under 3000, its normalized free cash flow is roughly 180. Dividing 180 by an expected return of 9% minus free cash flow growth of 5% (.09 - .05) yields a valuation for the Dow of 4500, less than half of its current market valuation. To justify a Dow value of 10,500, one has to lower the future expected investment return for the Dow to 6.7%.

From 1920 to 2003, Moody's Aaa corporate-bond yield averaged 5.9%. Recently, *Barron's* Best Grade Index has shown a current yield of 5.24% for top-grade corporate bonds. Assuming a forward rate of return of 6.7% for the Dow would imply an equity-risk premium of just 0.8% to 1.5%.

The preceding analysis will probably shock most investors. Conventional wisdom is that the Dow's earnings are much higher, and that its P/E ratio is much lower. Conventional wisdom, however, is based on some bizarre assumptions and beliefs.

A normalized 20 P/E ratio for the Dow would imply a normalized 18% return on equity (5% earnings yield x 3.6 book value multiple = 18%). While the Dow averaged an 18% return on equity over the prior decade, assuming a lasting return on equity anywhere near this figure is absurd, given the historical record.

Although there have been many short periods in the past during which the Dow Industrials' return on equity significantly exceeded 11% (such as the 1920s, when it also averaged 18%), an elevated return on equity has always come at the expense of future profits, and ROE has always reverted near its 11% average over each 20-year period. While the causes (excess credit creation, faulty accounting) may be contested, the results are incontestable.

Putting history aside, basic logic alone dictates that a sustained 18% ROE is impossible. A return of this magnitude would mean that American business as a whole is capable of lasting, monopoly-type profits. The truth is the exact opposite: Big Business' profit growth has consistently trailed broad economic expansion, with nominal GDP growth increasing at a 7% rate and Dow profit growth lagging behind, at near 5%, for nearly every 20-year period on record.

Small Margin of Safety

Current stock-market valuation levels have made the search for equities that possess a margin of safety a generally difficult task, and the job of professionally managing money even more difficult, given the myriad pressures and incentives to remain fully invested.

In response to this challenge, many investors have turned to a relative, rather than absolute, value approach.

The problem is that these investment approaches are radically different, despite some seeming similarities. In choosing relative value, investors subject themselves to the value of the broad market.

This is not a prudent choice, given the current valuation of large-cap U.S. stocks and the limits to these companies' profitability and growth, as demonstrated by the 11% solution.

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