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BARRON'S COVER

Triumph Of The Bull

Stocks look better than the alternatives

By **ANDREW BARY**

THE STOCK MARKET, to paraphrase Winston Churchill's comment about democracy, may not be perfect, but it looks better than the unattractive alternatives. The allure of equities over fixed-income securities, moreover, has been further enhanced by the new tax law.

With the sharp gain in the major market averages since their March lows, stocks aren't cheap by historical standards. The benchmark Standard & Poor's 500 index, at 988, trades for about 19 times projected 2003 operating profits, above the average price/earnings ratio of 15 over the past 20 years. The Dow Jones Industrial Average, at 9117, changes hands at about 18 times estimated 2003 earnings.

But the current market valuations need to be measured against other investments, chiefly bonds, which offer pitifully low yields and could pose plenty of risk. The S&P may be up 23% from its March lows, but it's back only to where it stood five years ago, as are the Dow Jones Industrial Average and Nasdaq Composite (see graphs below). The current S&P P/E is well below its peak of 25 in early 2000.

As for valuations, many stocks, including **Pfizer, General Electric, Microsoft, PepsiCo** and **American International Group**, trade at considerably lower P/Es now than they did in 1998.

BACK TO 1998

Stocks have rallied sharply from their March lows with the S&P 500 appreciating almost 25%. But the S&P, Dow Jones Industrial Average and Nasdaq are no higher than where they stood five years ago. Given rock-bottom rates, dividend tax relief and the prospect of improving corporate profits, the S&P and Dow could rise another 10% by year-end.



Source: Baseline

While technology has led the stock market this year, the best returns over the next six months could come from high-quality, dividend-paying stocks such as the ones shown in the table "[Focus on Dividends](#)¹." The most vulnerable group of stocks may be the pricey tech and biotech stocks that have run up so much in the first half. The speculative quality of the tech rally is apparent in the huge gains in stocks such as **Juniper Networks**, **Broadcom** and **Yahoo**, while tech leaders such as **International Business Machines**, **Oracle** and **Dell Computer** have enjoyed sizable but not outlandish gains.

Bonds, meanwhile, look dubious at current levels. The benchmark Treasury 10-year note yields just 3.1%, a 45-year low, while short-term rates hover just above 1%, and may be heading lower if the Federal Reserve cuts rates later this month, as many on Wall Street expect.

The after-tax yield on most Treasuries is 2% or less, meaning that investors are consigning themselves to low or no after-tax returns over the next decade barring the unlikely event of outright price deflation. Should bond yields rise one percentage point in the next year -- not outside the realm of possibility -- the 10-year Treasury note would drop about 8% in price, equivalent to 2½ years' worth of income. It's arguable that, over the next 12 months, there's as much risk in the 10-year Treasury as in the S&P index, and far less appreciation potential.

Junk bonds, which carried juicy 13% yields last October, now yield about 9% on average. That may look good in a world of 1%-2% inflation, but investors need to factor in default rates and taxes. Assume a normal level of defaults, and investors could be staring at 7% annual junk returns over the next few years, and less after taxes.

On Wall Street, the big debate is whether the market gains of the past three months amount to another bear-market rally that soon will be reversed or the start of a bull market.

Based on the super-low level of interest rates and the prospect of a mild recovery in corporate earnings, this rally looks sustainable, especially considering the \$5 trillion sitting in low-yielding accounts at banks, thrifts and money-market funds that could start to make its way into stocks. One gauge of potential liquidity, the ratio of money-fund assets to the Wilshire 5000 index, a broad market measure of 5,000 stocks, is way above its historical average (see graph "[Ample Liquidity](#)¹").

"We're in a saw-toothed bull market," says Byron Wien, senior investment strategist at Morgan Stanley. There could be a near-term setback for stocks; the summer has historically not been a great period for them and certain technical indicators, including sentiment and the relationship of the major indexes to their 200-day averages, indicate that stocks may have moved up too quickly.

"The consensus is that this is a cyclical bull market in a secular bear market. I don't agree," says Wien. "By the

end of 2003, the economy will be stronger and rates will be rising." If Wien is right, the Dow at year-end could be flirting with 10,000, roughly 10% above its closing level Friday, and the Standard & Poor's 500 might hit 1,100, a gain of 11%. (For another view, see the [interview](#)² with Ned Davis.)

The stock valuation models that factor in Treasury yields are flashing a strong buy signal. The so-called Fed model mentioned by Alan Greenspan in the late 1990s, which simply compares the forward earnings yield (the inverse of the P/E) of the S&P 500 to the yield on the 10-year Treasury, shows that the S&P is about 40% undervalued relative to a targeted level of over 1,600.

Wien's more sophisticated model, which employs Treasuries, corporate earnings growth and an equity risk premium, suggests that the S&P is 45% undervalued (see graph "Buy Signal"). Even if Wien's bullish profit-growth forecast of 10% annually is scaled back to 7%, the average of the past 40 years, the S&P is still almost 30% undervalued.

It can be argued that the Fed and Wien models spit out outrageously high stock valuations when interest rates get very low. But it would take an increase in the 10-year Treasury note to 5%, combined with an assumption of 7% annual profit growth, for stocks to be fairly valued now based on Wien's model.

It's tougher to make a case that the Nasdaq will match any further gains in the Dow and S&P this year because it has bested its brethren by a wide margin so far this year. Technology stock valuations, moreover, are by far the highest of any major sector of the market (see table "[Rich Technology Sector](#)"³). The Nasdaq, at 1626, has gained 21.8% so far this year, while the Dow is up 9.3% and the S&P 500, 12.4%.

The Nasdaq also looks vulnerable based on a long-term trend line stretching back to late 1989. The S&P 500 is up at an 8%-plus annual rate since then, while the Nasdaq has risen at more than a 10% clip, according to ISI Group.

It's expected that S&P operating profits will rise about 10% this year and another 10% in 2004 as Corporate America recovers from a depressed period from 2000 through 2002. S&P earnings are seen rising 6% in the second quarter and then increasing 12% and 21% in the third and fourth quarters, respectively.

It should be said that these operating earnings figures have their detractors, including Merrill Lynch's chief domestic strategist, Richard Bernstein, who has argued that operating estimates exclude a lot of bad stuff such as corporate restructuring charges.

Bernstein considers actual, unscrubbed S&P earnings as a better measure of corporate profitability because so many extraordinary charges are recurring. The Bernstein approach makes stocks look very expensive because 2002 S&P profits were under \$30, below the operating figure of \$48, owing to huge write-offs. The good news about 2003 is that operating profits aren't expected to be much different from reported earnings largely because corporations took so much pain in 2002.

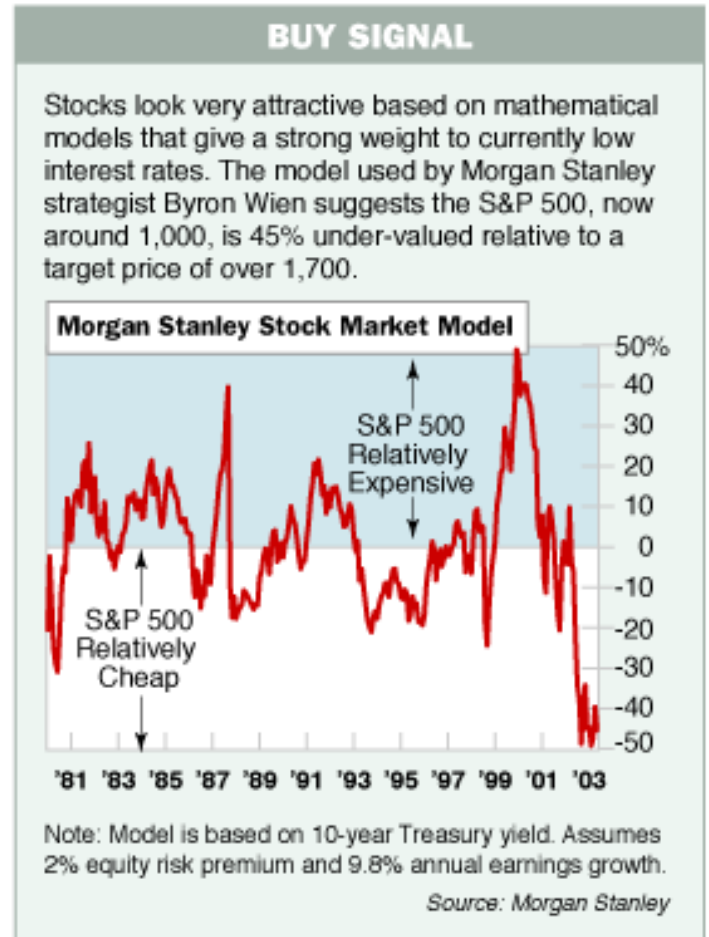


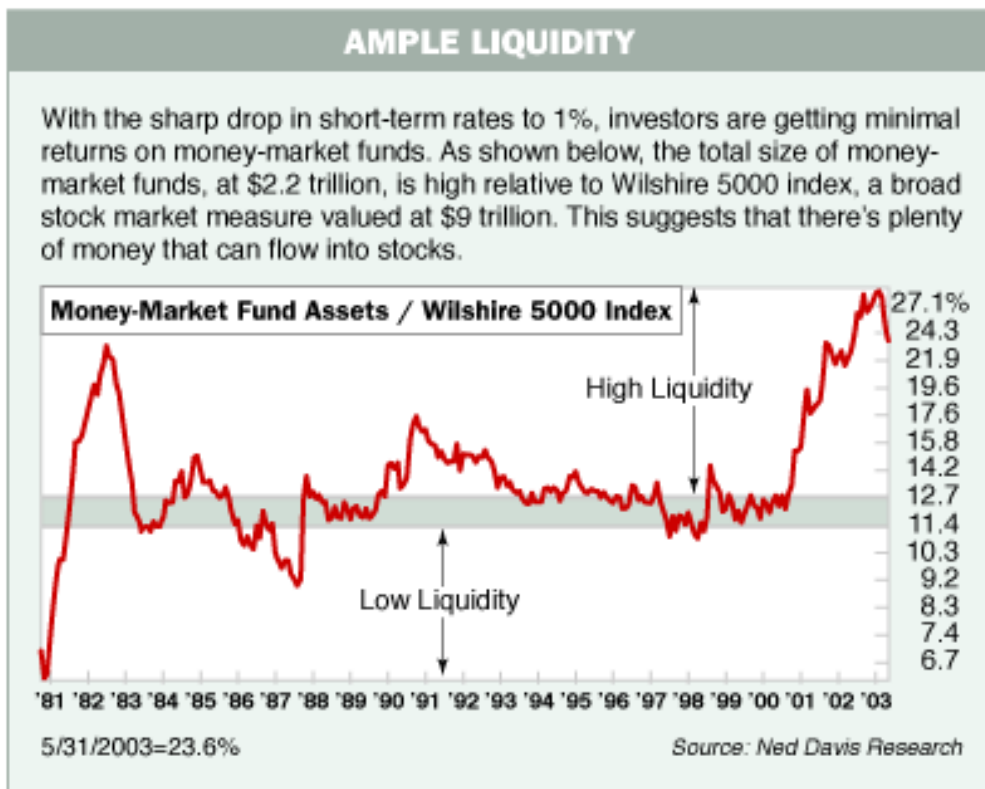
Table: [Focus on Dividends](#)⁴

U.S. fiscal, monetary, currency and tax policies all are favorable for stocks. Indeed, there rarely has been such a potent policy mix as the one now emanating from Washington. The federal budget deficit could run at \$400 billion in the coming year and short rates are at their lowest in over 40 years. Taxes on dividends, meanwhile, were cut to 15% from 35% and capital-gains taxes were reduced to 15% from 20%.

It's almost as if political and monetary authorities are conspiring to lift the stock market. Whatever happened to the famed bond-market "vigilantes" of the late 1980s and early 1990s, who sold bonds at times of strong economic stimulus programs? The vigilantes have gone soft. The new vogue among hedge funds and other big speculators is to buy billions of dollars of 2% and 3% Treasuries with high degrees of leverage using borrowed funds costing 1% in order to earn decent returns on low-yielding bonds. This strategy could end badly, as it did in 1994, if economic growth accelerates and inflation fears rise.

The Federal Reserve's current fear, deflation, looks like a remote threat. Concerns about falling prices may exist in the heads of the Fed governors, but the average American consumer doesn't see much evidence of it. From medical costs to college tuition to natural gas to homeowners' insurance to cable TV, prices are heading up.

As for valuations, tech stocks within the S&P trade at a significant premium to the rest of the index. The tech sector commands more than 30 times projected 2003 profits, about double the valuation of non-tech stocks in the index (see table "[Rich Technology Sector](#)⁵"). This calculation doesn't adjust for the heavy options grants by tech companies that would pinch their profits and boost their effective P/E ratios.



Based on projected 2003 earnings, the P/E ratio of tech to non-tech stocks is at the high end of the range for the past five years, except for bubble period in late 1999 and 2000. Prior to the late-1990s tech boom, the tech sector never traded at more than a 50% premium to the rest of the market.

"For tech stocks to go much higher, we either need P/Es to expand beyond what we've seen in prior tech rallies, or we need to get substantially more earnings improvement than we suspect," says Steve Milunovich, tech strategist at Merrill Lynch. Milunovich's colleague Bernstein argues that the tech group ought to trade at a discount to the rest of the market because of higher earnings volatility and shorter periods of competitive advantage.

Intel, for instance, is a hot stock this year, rising 37% to 21.36. But for all the excitement about the chip maker's improving prospects, its projected profits this year of 65 cents a share are less than what it earned in 1997. That hardly qualifies as a growth stock. Intel has been rewarded with a P/E of 34 on estimated 2003 earnings.

It's unlikely that tech stocks will trade down to a market multiple anytime soon, if only because portfolio managers who want to juice up their performance in a bull market instinctively gravitate toward technology. Many tech stocks, including much of the semiconductor and semiconductor-capital-equipment sector, have morphed into trading vehicles with valuations that are difficult or impossible to justify based on fundamentals.

Tech analysts are looking for 17% annualized profit growth in the next few years, a very ambitious target.

Many investors wonder about the earnings growth rate implied by the current levels of the major indexes and stocks. Morgan Stanley has sought to provide answers about implied earnings growth rates for various sectors and for the entire S&P 500 (see table "[Rich Technology Sector](#)"⁶).

At its current value, the S&P now discounts roughly 8% annual growth, while tech anticipates 12% annual increases, according to work by Steve Galbraith, chief domestic strategist at Morgan Stanley. Some would argue that with the S&P trading at 19 times estimated 2003 operating profits and for about 17 times estimated 2004 earnings, the projected earnings growth rate ought to be higher than 8%.

Yet Galbraith says that earnings growth doesn't need to run in double digits to justify the current S&P level. Over the past 20 years, the index has traded at an average P/E of about 15, roughly double its earnings growth rate of 7% annually.

Low-P/E sectors of the stock market, notably financials and energy, discount just 5% growth, according to Morgan Stanley. It's admittedly harder for financial companies to differentiate themselves and competition is fierce, but current valuations don't demand much earnings growth.

Regional banks, for instance, have been laggards this year amid concern that falling rates will cut their interest margins. There indeed has been some pressure on margins, but many of the stocks, including **PNC Financial**, **Comerica** and **Wachovia**, now trade for 12-to-13 times projected 2003 profits and often carry dividend yields of as much as 4%. The country's best-run regional, **Wells Fargo**, trades for a modest 14 times projected 2003 earnings. The regionals look attractive relative to the major securities brokers such as **Goldman Sachs** and **Morgan Stanley**, which have run up this year owing to their operating leverage in equity underwriting, merger-advisory and other high-margin businesses revive.

Energy stocks aren't badly valued and carry solid dividend support. **ChevronTexaco**, **ExxonMobil**, **Royal Dutch Petroleum** and **BP**, the four global "super-majors," all have moved up this year, yet their P/Es are modest, save for ExxonMobil, which commands its usual premium to the group. ChevronTexaco, BP and Royal Dutch have yields in the 3% range and P/E ratios of around 14 based on estimated 2003 earnings. Their yields stack up well relative to Treasuries and high-grade bonds.

Assuming no reduction in their dividends, ChevronTexaco, Royal Dutch and BP need show no appreciation in their shares to beat the return on the 10-year T-note over the next decade.

One concern about the big oils is that 2003 profits are running above "normal" levels owing to unsustainably high oil and gas prices. Yet those fears are fading as oil moves back over \$30 a barrel and natural gas remains stubbornly around \$6 per million British thermal units.

Other dividend-paying stocks are listed in the tables. The first bunch, including **Altria Group**, **Verizon Communications** and **Eastman Kodak**, carry relatively high -- and secure -- dividends in the 4%-5% range, but their growth prospects generally are lower than those of the second group, which includes **Pfizer**, **Gillette**, **General Electric** and **Wells Fargo**. The second group, with dividend yields in the 2% range, could be capable of 10% annual profit gains, although many are targeting higher growth.

The dividend rate of the entire S&P index is 1.7% and 2.2% for the Dow Industrials. Many strategists think dividends are apt to rise, thanks to the tax-law changes. Corporations no longer have a tax incentive to buy back stock rather than pay dividends.

The dividend-payout ratio on the S&P -- dividends as a percentage of operating earnings -- is low at around 33%. In contrast, the DJ Euro Stoxx 50, the leading companies in Europe, pay an average dividend of 3.4% with a payout ratio of around 50%. If the S&P dividend payout ratio moved up to 40%, the S&P dividend yield would rise to about 2%. That's admittedly low by pre-1990 standards, when the S&P generally yielded 3% or

[more.](#)

Dividend-oriented investing is expected to become more important in the coming years because of lower taxation and the prospects of single-digit annual stock appreciation. To benefit from a dividend-oriented strategy, investors need to hold stocks directly or buy low-cost mutual funds such as index funds.

Many equity mutual funds aren't effective dividend vehicles because they eat up too much of their income in fees, given the industry's overall expense ratio of about 1.5%. "The typical high-cost mutual fund is simply inappropriate for anyone seeking income," says Jack Bogle, the former head of the Vanguard Group of funds and a champion of low-fee funds.

Assume a fund with an S&P-type portfolio yielding 1.7% and an expense ratio of 1.5%. The investor gets just 0.2% before taxes. Bogle notes that the effective cost of the typical fund, including transaction costs, is closer to 3%, which is a hefty chunk of the 7%-ish yearly equity total returns that many foresee for the next decade.

For those who want to go the fund route, the no-load Vanguard Equity Income Fund yields more than 2% and has an expense ratio of 0.47%, according to Morningstar, which rates it four stars. Its biggest holdings include the aforementioned ExxonMobil, Verizon and ChevronTexaco. Morningstar also recommends Dodge & Cox Stock and T. Rowe Price Equity-Income funds among low-cost, no-load, dividend-focused funds.

So as Churchill might have said, stocks may be the least attractive form of investment -- except for all others.

E-mail comments to editors@barrons.com⁷

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Focus on Dividends

The combination of low rates and dividend tax relief could benefit stocks that pay appreciable dividends. Shown below are stocks with high dividends and muted growth outlooks and those with more modest dividends and solid growth prospects. Among the hottest group of stocks this year are technology and biotechnology issues. Given their run-up and high valuations, these tech and biotech issues look pricey.

High-Yielding Bond Alternatives

Company	Price	Price Dif Ytd	52 Wk Hi-Lo	Earnings Per Share		P/E Ratio		Dividend Yield	Payout Ratio*	Value (bils)
				'03E	'04E	'03E	'04E			
Altria Group	\$42.90	5.8%	\$57-27	\$4.62	\$4.96	9.3	8.6	6.0%	57 %	\$88.7
Eastman Kodak	31.11	-11.2	42 - 25	2.35	2.74	13.2	11.4	5.8	67	9.0
Con Edison	43.17	0.8	47 - 32	2.89	2.90	14.9	14.9	5.2	73	9.2
J.P. Morgan Chase	34.70	44.6	37 - 15	2.37	2.74	14.6	12.7	3.9	76	69.2
Bristol-Myers Squibb	27.05	16.8	29 - 19	1.60	1.69	16.9	16.0	4.1	92	52.3
PNC Financial Svcs	49.33	17.7	56 - 32	3.80	4.19	13.0	11.8	3.9	48	14.0
SBC Communications	26.02	-4.0	34 - 18	1.61	1.61	16.2	16.2	4.3	51	86.3
Albertson's	19.50	-12.4	34 - 17	1.71	1.76	11.4	11.1	3.9	38	7.3
Verizon Comm	39.79	2.7	45 - 26	2.73	2.75	14.6	14.5	3.9	52	108.8
ChevronTexaco	75.62	13.7	89 - 61	5.78	4.81	13.1	15.7	3.7	51	80.7

Solid Yields, Solid Growth Outlook

Company	Price	Price Dif Ytd	52 Wk Hi-Lo	Earnings Per Share		P/E Ratio		Dividend Yield	Payout Ratio*	Value (bils)
				'03E	'04E	'03E	'04E			
Washington Mutual	\$42.93	24.3%	\$44- 27	\$4.41	\$4.77	9.7	9.0	2.8%	28 %	\$40.6
Exxon Mobil	38.20	9.3	42- 29	2.15	1.98	17.8	19.3	2.6	45	257.0
Merck	59.30	4.8	61 - 38	3.41	3.72	17.4	15.9	2.4	45	133.1
Wells Fargo	51.53	9.9	55 - 41	3.65	4.05	14.1	12.7	2.3	34	87.1
Fannie Mae	67.07	4.3	80 - 58	7.36	8.08	9.1	8.3	2.3	22	66.7
Marsh & McLennan	53.75	16.3	54 - 34	2.78	3.17	19.3	17.0	2.3	45	28.8
General Electric	31.07	27.6	33 - 21	1.61	1.76	19.3	17.7	2.4	5	309.1
Pfizer	33.52	9.6	38 - 25	1.76	2.06	19.0	16.3	1.8	35	267.2
Gillette	32.88	8.3	37 - 27	1.26	1.40	26.1	23.5	2.0	56	34.3

Pricey Tech And Biotech Stocks

		Price	52 Wk	Earnings Per Share		P/E Ratio		Dividend	Payout	Value
Company	Price	Dif Ytd	Hi-Lo	'03E	'04E	'03E	'04E	Yield	Ratio*	(bils)
Yahoo	\$29.70	81.7%	\$31- 8	\$0.35	\$0.46	84.9	64.6	0.0%	0 %	\$17.5
Broadcom	26.77	77.8	29 - 9	0.38	0.60	70.4	44.6	0.0	0	7.3
Juniper Networks	13.59	99.9	15 - 4	0.08	0.15	169.9	90.6	0.0	0	5.1
Kla-Tencor	47.6	34.6	52 - 25	0.66	1.04	72.1	45.8	0.0	0	9.0
Applied Materials	15.62	19.9	22 - 10	0.13	0.45	120.2	34.7	0.0	0	25.7
Texas Instruments	18.49	23.2	28 - 13	0.36	0.68	51.4	27.2	0.5	3.0	32.0
Maxim Integrated Prd	35.75	8.2	47 - 20	0.91	1.12	39.3	31.9	0.4	0.9	11.5
Genentech	73.70	122.3	76 - 25	1.12	1.40	65.8	52.6	0.0	0	37.5
Amgen	65.03	34.5	66 - 30	1.85	2.27	35.2	28.6	0.0	0	83.6
eBay	100.84	48.7	104-50	1.46	2.07	69.1	48.7	0.0	0	31.1

E= estimated

*Payout ratio is annual dividends divided by trailing 12-month profits

Source: Thomson Financial/Baseline

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