Equity Returns in Range-Bound Markets

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Sources of Equity Returns

There are two sources of total return from common stocks: income and capital appreciation. Dividend income is a simple concept: established companies determine that the best use of some of their cash flow is to return it to the shareholders. Companies which pay dividends work hard to protect their dividend payout, as any disruption generally reflects poorly on the stability of their business.

Capital appreciation return is slightly more complex. The equity of a company can be valued in a number of ways. One method of valuation derives a theoretical value based on the present value of its future cash flows. In this approach, the theoretical components of a stock's present value are 1) the value of current and expected future cash flows and 2) the rate at which future cash flows are discounted back to the present. Capital appreciation occurs when cash flows increase (profit growth), when there is a decline in interest rates (discount rate decreases), or when investors become willing to pay more for their claim on cash flows (multiple expansion).

Range-Bound Markets in History

Range-bound markets have been a prominent feature of our capital markets throughout the last century, though they may be difficult to recognize. The popular financial press tends to speak simply of "Bull Markets" and "Bear Markets", both of which are accessible terms but their usage also creates a false dichotomy. In reality, the long story of common stock returns in the U.S. is essentially our story of democratic capitalism: the value of freely-deployed, rational equity capital tends to increase over time. But there are also prolonged periods in history when stock prices fluctuated yet failed to produce new highs—stock prices traded within a defined range. The terms *secular* and *cyclical* distinguish between the varieties of markets. A cyclical market corresponds to the business cycle, whereas a secular market characterizes a longer trend.

Looking back through history, we see that trends in stock returns can be segmented into secular bull markets and secular range-bound markets. Each of these secular markets has been comprised of cyclical bull and bear markets. In these terms, the current massive re-pricing of risk is considered a cyclical bear market. But the question remains: is this correction within the context of a secular bull market or a secular range-bound market?

It is noteworthy that past range-bound markets have tended to follow periods of major macro economic activity, during which secular bull markets prevailed. For example, the range bound market of 1906-1924 marked a period of capital market consolidation after the industrial revolution. The 1937-1950 range-bound market followed the excesses of the 1920s and the cyclical bull market that was subsequent to the market crash of 1929. The range-bound market of1966-1982 followed a tremendous period of growth fueled by pent up consumption demand (suppressed during the depression and World War II), commercial technological advancement, and cold-war defense spending.

1982 marked the beginning of the great bull market of the last century, which lasted until March of 2000. This period was fueled by deregulation, globalization, the end of the cold war, and the technology boom. This most recent bull market saw both real economic growth (profits grew), steady and significant declines in interest rates (the discount rate decreased) and the near tripling in the average price-to-earnings ratio for companies in the S&P 500 Index (multiples expanded). It was a long-period of major economic growth and change. With the major stock indices trading today well below their 2000 levels, it is clear that the last 8 ½ years have been a period of retrenchment—a *secular* range-bound market.

How Long Will It Last?

Returning to our three sources of capital appreciation, we ask ourselves whether we can expect profits to grow, whether the discount rate will decline, and whether multiples should be expected to expand? Cash flows are mainly a function of corporate profits as a whole which, in turn, are a subset of Gross Domestic Product. Over time, corporate profit growth cannot continue to out-pace GDP growth because, mathematically, profits would eventually become larger than GDP. Historically, corporate profits have comprised between 5 and 12 percent of GDP. As a percent of GDP, current corporate profits represent approximately 11%, which is down from 12% in 2007, but still well above the long-term mean of 8-9%. We achieved this extraordinary net margin largely through efficiency gains, both from technology improvements and via the reduction of payroll expenses through access to cheaper foreign labor. With that said, we conclude that it is very unlikely that corporate profit growth in the aggregate will out-pace general GDP growth in the next several years. In fact, we are more likely to see net margins revert to the mean.

What about the discount rate? The starting point for an applicable discount rate for a stock is the risk free rate plus an equity risk premium. Using the yield on the 10 year U.S. Treasury Note as an approximation of the risk free rate, we observe that rates declined from 15.84% in late1981 to 3.80% today. Though 10 year Treasury yields may never again reach 15%, it is obvious that they also have very little room to decline. Finally, investor confidence during range-bound markets tends to decline as memories of earlier bull market returns clash with the reality of the current lack of sustained progress in investment values. Thus we do not see a catalyst for significant, general market multiple expansion.

Putting a time frame on the current range-bound market is difficult at best. We estimate that we could be in this present range for several more years.

Range-Bound Investment Disciplines

We concede that the above observations pertain generally to the stock market and the U.S. economy overall. We firmly believe that certain companies will display more favorable cash flow trends than the averages suggest. These are precisely the companies in which we look to invest. On the other hand, stock index returns are simply a collection of an un-managed array of individual stock returns. The corollary is that passive investing may not prove as attractive as it has in the past. The success stories of the next 5 years are more likely to be those of active managers following disciplined investment processes.

We also believe that with profit margins stagnant or declining, the price-to-earnings multiples of stocks will generally decline as well. We are both reducing our target earnings multiples and assigning a higher weight to discounted cash flow valuation in our analytical process. Indeed, the severity of the current correction has already produced certain equity valuations which even Benjamin Graham would find attractive. And, as many academic studies have demonstrated over the years, we anticipate that the discipline of buying companies with low multiples will continue to pay off.

Lastly, income really matters. If capital appreciation potential is constrained, then investing in companies which are committed to distributing meaningful amounts of cash to shareholders will enhance total return. We are cautious to not be driven by dividend yields, though. Currently, many financial companies are distributing such large amounts of their cash flow as dividends that they have an inability to retain sufficient cash for future growth projects. However, investing in companies which are both capable of growing their free cash flow and which are trading at a discount to our estimate of intrinsic value will, we believe, continue to be a sound investment process.

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