Bradley, Foster & Sargent, Inc.
Investment Management

Where's the Stock Market Headed?

> Let me again suggest that the future has never been clear to me (give us a call when the next few months are obvious to you - or, for that matter, the next few hours).
> -Warren Buffet, 1966

For many of us in the investment business, the first question that is often asked of us by clients and friends is: "Where's the market going?" Or phrased another way, "What do you think about the market?" It really seems to be an entirely appropriate question to be directed to investment professionals, since a large percentage of our waking hours is spent analyzing companies, industries, sectors of the stock market and the stock market itself. When asked this question, it is, therefore, natural for many investment professionals to sound knowledgeable about the direction of the stock market - either because they think that they can accurately forecast its future behavior or because it might be embarrassing for them to admit that they don't know where the stock market is headed.

At Bradley, Foster and Sargent, Inc., however, we are not embarrassed about admitting that we don't know which way the stock market is headed over the short term. We are also prepared to admit that we don't know where such things as interest rates, the dollar, or the price of oil are headed. Furthermore, we find ourselves in very good company in this regard. What do investors such as Warren Buffet, Peter Lynch and John Templeton have in common? All say that it is impossible to predict the direction of the stock market with any degree of regularity. What is important to understand is a company, its industry and how the stock market values them. The stock market is made up of thousands of companies and dozens of industries, and at any given time there are companies and sectors which we believe are overpriced and those that are more reasonably priced.

While we are pleased that the optimism expressed in our written investment outlooks over the past six or seven quarters has generally been on target, we nonetheless maintain that it is not possible to predict future stock market movements with any degree of consistency. There are simply too many variables which influence the market's direction. These include factors such as inflation, interest rates, liquidity, GDP growth, fiscal policies, corporate cash flow, global

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trade, political events, regulation, funds flowing into the stock market, stock market valuation, wars and other acts of God.

The realization that one cannot consistently predict the future direction of the stock market leads us away from attempts to operate as market timers. On the other hand our investment approach is validated by some persuasive research compiled by Ibbotson Associates. The perils of market timing are demonstrated by their findings that while stocks outperformed Treasury bills cumulatively between 1952-1992 by a factor of approximately 10 times, the total cumulative return for stocks would have been lower than T-bills during this period if an investor was not invested in stocks for just 5% of these 492 months. In other words, the need to be near perfect in market timing is essential.

How do we seek to achieve excellent investment performance if it is not through market timing? Our investment approach has two key components: first, to purchase top quality, established growth companies (identified through rigorous quantitative and qualitative research); and secondly, to buy the shares of these companies at reasonable prices, which provide a "margin of safety". Buying great companies at reasonable prices takes patience, because much of the time they sell at rich multiples. We look for either a specific event, an industry wide correction or a stock market sell-off to bring the share price to a reasonable level. Once we have successfully executed this approach with a stock, we tend to hold it for the long term. On the other hand, if a company's deteriorating outlook warrants the sale of the stock, we do not hesitate to do so without letting potential capital gains taxes drive the decision.

There is one important caveat to the above comments about market timing. Once in a long while, perhaps once every ten or twenty years, the stock market does present valuations which are extreme - either extremely undervalued or overvalued. A good example of this comes from Warren Buffet's legendary record as an investor. In 1969, after a bull market which ran for almost two decades, valuations were at such an extreme that Buffett liquidated his investment partnership because he didn't wish "to embrace an investment approach which I don't fully understand, have not practiced successfully, and which, possibly, could lead to substantial permanent loss of capital". As it turned out, Buffett bailed out right at the top of the market. In 1974, with most stocks down 70% or more, the valuations were so low that Buffet was buying major positions in dozens of high quality companies. Again, by October, 1987, Buffet had reduced his stock holdings to only three companies - Coca Cola, Geico and Capital Cities/ABC.

Thus, Buffett, in a career which has spanned 40 years of investing, only twice saw the stock market valued at levels which caused him to exit.

The question for us, then, is: With the Dow Jones today at 6,094, is the stock market so overvalued that it is time to head for the exits? We don't think so. Analysts estimate that the 1996 P/E for the Dow Jones is 16.2, while the P/E on estimated 1997 earnings is 14.2. The average P/E of the Dow Jones this century has been slightly over 14. If we focus on the broader Standard and Poor 500 stock index, we see that most analysts estimate earnings of $40 for 1996. With the S&P 500 at 711, this translates into a 1996 P/E of 17.8. Inflation continues to run at less than 3%, and over the past 40 years when inflation has been below 3.5%, the average P/E ratio for the S&P 500 has been 16.5. Byron Wien of Morgan Stanley has constructed an interesting chart based upon his own computer model. It suggests an equilibrium level between stocks (S&P 500) and bonds - assuming various levels of S&P 500 earnings and interest rates for yields on long U.S. Treasury bonds. The mid point in the chart below is 643 with variances of 21% up or down. With the U.S. economy on a path of moderate growth and little or no excesses, the key variable is the inflation rate, which in turn will effect the level of U.S. interest rates.

Interest Rate and Earnings Sensitivity Analysis For the S&P 500

	S&P 500 Equilibrium Point* with Long Treasury Yields at:				
Earnings ($)	**6.5%**	**7.0%**	**7.5%**	**8.0%**	**8.5%**
39.00	695	639	590	546	508
40.00	709	652	601	557	517
41.00	722	664	613	567	526
42.00	736	677	624	577	536
43.00	750	689	635	588	545
44.00	764	702	647	598	555
45.00	778	714	658	609	564

**Stocks and bonds equally attractive.*

Source: Morgan Stanley Research Estimates

Byron Wien 9/3/96

Good charts like this one tend to make one believe that the author knows where the market is headed. However, this chart is just a well constructed guess about possible market parameters. Wien, a highly regarded professional investment strategist, finds it difficult to consistently predict the market as we all do. He gave his clients the sell signal this summer, following this up with a public forecast that the Dow Jones would fall over 1,000 points to 4,500 by this Fall, and was wrong. (For the record, we mean no disrespect of Mr. Wien, whose observations we carefully monitor and consider. It is just that he, too, can not always be correct.)

Finally, while we will venture no predictions about the future direction of the market at this time, some comments about the market's current level of valuation are in order. Now, as always, we note that some sectors of the stock market are quite expensive, while others are more reasonably valued. However, at present, there are very few bargains. We continue to believe that the basic investment themes of U.S. companies profiting from globalization, the importance of technology, and the consolidation of the financial industry are still intact and will impact the stock market positively. These themes often run for a decade or more. We are in the fifth year of an economic recovery. As the bull market extends its run, we will maintain our emphasis on well established growth stocks which are somewhat immune to the economic cycle. We also continue to favor the financial stocks which have avoided excesses so far this cycle and which sell at reasonable multiples. The recent technology conference that we attended in Baltimore encouraged our belief that the dynamic growth in PC, software, and internet related companies is still in its early phases. Finally we continue to invest in some of the best quality REITs which produce excellent total return with less price volatility. We will continue to emphasize prudent asset allocation and good diversification, in an effort to maintain the gains of the past nine consecutive calendar quarters during which equities have been higher than the preceding quarter. But we still trust the old German adage: "Die Bäume wächsen nicht in den Himmel hinein." (Trees don't grow to Heaven!).

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