The Dow Jones at 36,000: The Long View

> October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February.
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> Mark Twain, *The Tragedy of Puddn'head Wilson*

It is important in investing, as in life, to get the main things right. The main thing about the U.S. stock market over the past several decades has been the astonishing power of the bull market. From August 12, 1982, the start of the greatest bull market in this country's history, through June 30, 1999, an investment in the Standard & Poor 500 Index (with dividends reinvested) would have turned $10,000 into $194,000. In less than 17 years, an investment in the broad stock market increased 19.4 times. Moreover, the stock market's rate of total return has accelerated over the recent past. For the four years from 1995 through 1998, the S&P 500 Index showed an annual total return of at least 23% a year - an unprecedented feat in modern stock market history. Many well-regarded stock market professionals have been warning with increasing zeal that the U.S. stock market is significantly overvalued. In our own quarterly investment commentaries, we have written that the S&P 500 Index has never been so richly valued, based on historical P/E ratios. And indeed, since the July 19 record S&P 500 Index high of 1420, the stock market has run into stormy weather with the broader indices down more than 10% through September. With October's notorious volatility ahead and potential Y2K troubles looming, is this the beginning of the bear market that many have been forecasting? Or is the stock market significantly undervalued as James K. Glassman and Kevin A. Hassett claim in their new book, *Dow 36,000*? This is one to get right.

Stock Market's Decline Since July, 1999

Over the past several months, the stock market hasn't acted like it is undervalued. Far from acting well, the stock market has seemed to be in a stealth bear market. One of the broadest indices, the Value Line Index was down 10.3% during the third quarter, while the Wilshire Index declined 6.9%. The S&P 500 Index (total return) was also down by 6.3% during this period. The breadth of the stock market also has been very narrow with the advance/decline line showing far more declines than advances. In fact, while some of the indices are up so far this year, six of the eleven S&P 500 industry sectors are down year-to-date, and the 100 largest stocks in the S&P 500 have fallen an average of 20% from their 52 week highs. For the first nine months of 1999, the broadest measure of market performance, the Wilshire Index, has showed an increase of only 3.5%, while the S&P 500 Index showed a total return of 5.32% for the same period. In addition, with the Federal Reserve having raised interest rates twice and long-term interest rates up more than 100 basis points this year, long U.S. Treasury bonds show a total return of

-7.21% so far in 1999. In general, it has been a difficult year, and investors have approached the stock market with greater caution. Net inflows to equity mutual funds were only $112 billion during the first eight months of 1999 compared to $132 billion for the same period last year, according to the Investment Company Institute.

The Astonishing Wealth Creating Power of the U.S. Stock Market

The stock market's performance over the last quarter wouldn't appear to be a good omen for the predictions in Glassman's and Hassett's new book, *Dow 36,000*, which calls for the Dow Jones Industrial Average to rise to 36,000 by 2004. However, Glassman and Hassett do emphasize that stocks are volatile and risky over the short term; they make their case on the basis of the long-term performance of the U.S. stock market. Taking data from Ibbotson Associates, they demonstrate how a $10,000 investment in stocks similar to the S&P 500 just before the stock market crash in October, 1929 would have grown. By the end of 1998, the stocks would have been worth $8.4 *million* - if the investor had held them through thick and thin and reinvested the dividends. The authors show how it would have taken until the end of 1944 - almost fifteen years to break even. By 1960, despite the Korean War and the U-2 crisis, the stocks would have increased 9.3 times. By 1975, in spite of the Vietnam War, Watergate, the OPEC Embargo and all the turmoil of the period, the stocks would have grown to $262,000. By 1985, despite the high inflation years and the difficult stock market, the stocks would be worth $999,000. By the end of 1998, they would have grown by a factor of 841 to be worth $8.4 million.

The authors also show that stocks produced positive returns in 53 years of the past 73 years. In 20 of these years, one would have had a loss and in 9 of these years, a double-digit loss in the stock market. However, if one held a diversified portfolio of stocks for *any* 20-year period since 1926, the worst gain that one would have had would be 84%. And for any 15-year period, one would *never* have had a loss - even at the worst starting point, October 1929. Thus, the authors believe that the stock market is highly risky over the short term but has been a money machine for investors - *over the long term*.

Then Glassman and Hassett show that the U.S. stock market has outperformed the U.S. Treasury bond market in real terms over the long run. Using Ibbotson's data again, they demonstrate that the worst inflation adjusted return for stocks over a twenty-year period was an annual average of plus 1%. For bonds, however, the worst was minus 3.1% and for Treasury bills, it was minus 1.8%. They write: "Over one-year periods, stocks have outperformed bonds only 61% of the time, but over twenty-year periods, stocks beat bonds 92% of the time; over thirty-year periods, 99% of the time….in the [stock] market, risk vanishes with time".

Thus their first premise is that a diversified portfolio of stocks over the long term is no more risky, in real terms (i.e.; adjusted for inflation), than an investment in bonds issued by the United States Treasury. Yet stocks have historically paid investors a large premium - about seven percent annually more than bonds; that is, they have provided an average annual return 7% higher than provided by bonds. The authors believe that this equity risk premium is based on the erroneous assumption of investors that the stock market is so risky that those who invest in it should get a significantly higher return. However, since their analysis indicates that this risk does not exist, the correct valuation for stocks is one that equalizes the total flow of cash from stocks and bonds in the long run. For this to take place, the Dow Jones, in their view, should rise to about 36,000. The proper price/earnings ratio for good growth stocks to equalize cash flow between stocks and bonds is approximately 100. In theory, the Dow should rise to 36,000 now, but the authors believe that it will probably take four or five years to happen.

Much of the rest of *Dow 36,000*, which is an enjoyable and thought-provoking read, is taken up with the mathematics to prove their theory - especially how the growth of earnings (and ultimately dividends) in a quality growth stock will put more cash in the pocket of an investor than will a bond. The authors provide the following powerful example: If one had invested $1,000 in each of the thirty Dow stocks in 1977, one would have received cumulative dividend payments over the next 20 years which would have exceeded interest payments from an equal $30,000 in Treasury bonds by 50%. In addition, your $30,000 Dow investment would have grown to $176,698. The authors show that the growth rate of dividends for U.S. companies since 1946 has been 6.2%.

The three main numerical determinants in their book are: the interest rate on long-term U.S. Treasury bonds, the dividend yield on stocks, and the expected long-term growth rate of those dividends. Using 5.5% as the interest rate on long-term Treasury bonds and a "conservative" expected long-term growth rate of dividends of 5%, they demonstrate mathematically how the dividend yield for the stock market should only be 5%. (This assumes, of course, that there should be no risk premium for stocks over bonds.) Currently the dividend yield on the Dow Jones is approximately 1.5%, which would mean that the Dow would need at least to triple to 36,000, in order for stocks to be valued correctly. They also run the numbers using inflation adjusted figures for stocks, bonds, and T-bills, which come up with the same end result. Finally, the authors utilize both earnings and cash flow to show that another methodology, which does not use the dividend growth approach, corroborates their conclusions.

Are Glassman and Hassett Correct?

We don't know. This may seem to be a cop out, but Glassman and Hassett aren't sure either. They write with admirable humility, stating that their approach might be useful in explaining why the stock market appears to be overvalued based upon traditional measures. They also recommend a model asset allocation, which includes both bonds and cash, depending upon age and other circumstances, as they realize that the stock market can be dangerous to those who do not approach it with adequate respect. We agree with their sentiments.

The linchpin of the Glassman and Hassett methodology is the interest rate of long Treasury bonds. As this interest rate increases, as it has throughout 1999, their formula calls for a lower and lower valuation of the Dow. If the interest rate of the 30-year U.S. Treasury bond increases to 6.5%, their dividend growth formula calls for the yield on the Dow Jones to be 1.5% - exactly where it is now. This would mean that the Dow at

10,500 is fully valued. On the other hand, if long-term interest rates were to decline and go to 5% or even lower, there approach calls for a Dow of 36,000 or more. Their method is perhaps too sensitive to the level of long-term interest rates.

Will the Dow Jones reach 36,000? Yes, we are strong believers that it will happen. The question is not: Will this happen? The question is: How long will it take? Take your pick:

Current Level of Dow	**Average Annual Return of Dow**	**Years**	**Date**
10,500	5%	25	2024
10,500	5 years at 0%; 11.8 years at 11%	16.8	2017
10,500	11% (historical average annual rate)	11.8	2010
10,500	25% (Glassman/Hassett Forecast)	5.5	2004

Summary

Are stocks overvalued? Glassman and Hassett notwithstanding, yes! Some of them certainly are. Many of the Internet companies definitely are. Perhaps some of the technology companies as well. Are some stocks undervalued? Yes, there are many good companies whose stocks have been savaged in this most recent correction. The financial and global consumer industries have seen price corrections of up to 50% during the past year. Many of these precipitous declines seem overdone to us. In general, the level of the stock market earlier this year seemed to get ahead of itself; earnings needed time to catch up with prices. That process is underway. Third quarter earnings for the S&P 500 Index are forecast to be up 20% over last year. We now expect 1999 S&P 500 operating earnings to be at least $50 and 2000 earnings to be at $55 or more. This means the P/E on estimated 2000 S&P 500 earnings would be about 22.5. While not inexpensive, the low level of inflation, strong corporate earnings, budget surplus, technological revolutions, strong demographics and good liquidity justify an equity risk premium which is less than the market has traditionally demanded. In the meantime, we believe that the astonishing wealth creating power of the U.S. stock market is well documented, and our approach will be to continue to seek to purchase quality, growth companies at good prices. The market has rewarded such an approach in the past and will continue to do so tomorrow.

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