Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

October 2013

Time in the Market – Not Timing the Market

> 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.
>
> Mark Twain, *The Tragedy of Pudd'nhead Wilson*

As the U.S. stock market has advanced during the course of 2013, not a few of our clients have asked us: "How long will this bull market continue?" As always, when asked to forecast short-term movements in the stock market, we respond that while we seek to make thoughtful forecasts, we readily admit that it is impossible to make predictions with any consistent accuracy. This is because there are so many factors that influence the stock market in the short term – corporate earnings, inflation and interest rates, investor psychology, political climate, Federal Reserve policy, liquidity, geopolitical events, funds flow, and business and consumer sentiment. Thus we believe that no investor can say with any certainty where the stock market will be in a week, a month, or even a year. Mark Twain's famous quote above from *Pudd'nhead Wilson,* written in 1893, humorously emphasizes the perils of speculating in stocks at any time of the year. A century later, market analysts compiled data which proved Twain wrong, showing that the U.S. stock market's performance in September has been the worst of all the months by far. In fact, according to Jeremy Siegel in *Stocks for the Long Haul*, one dollar invested in the Dow Jones only in the month of September from 1890 through 1996 would be worth only 26 cents. And the month with the second worst investment performance in the S&P 500 since 1926 has been October.

Aside from the stock market's seasonal behavior (such as "sell in May and go away") which only holds true a majority of the time, what we at Bradley, Foster & Sargent seek to emphasize to our clients is the investment performance of the U.S. stock market over the long haul. Despite the near systemic failure of the U.S. financial system during the Panic of 2008-2009, which caused the Great Recession, and the anemic economic recovery over the past four years, the stock market has rebounded dramatically from its March 6, 2009 low of 666, as the chart below shows:

S&P 500 Index
September 2007 – September 2013

As this commentary is being written, the S&P 500 is trading at 1690 – 7.2% above its October, 2007 high. Including dividends reinvested, the S&P 500's total return for this frightening six-year roller coaster ride has been approximately 24% – remarkably good, considering what has transpired. Nevertheless, many investors, having watched in horror as their portfolios dropped 50% or more during the Panic, do not wish to go through this again. Thus, as the bull market has persisted over the past months, a number of our clients have been tempted to sell. We have counseled our clients with a long-term perspective (ten or more years) to stay invested in the stock market, as there is a strong probability that stocks will continue to provide the best long-term returns of any asset class in the decades to come, as they have in the past.

The Remarkable Wealth-Creating Power of the U.S. Stock Market

Although there is some reliable data on the performance of the U.S. stock market as early as the beginning of the 19th century, accurate and precise performance data on the broader U.S. stock market is only available starting in 1926. This was the date that Standard & Poor's commenced compiling its index. The table below presents average annual returns for large capitalization stocks for the 87-year period which commenced with the inception of the S&P 500 in 1926 through 2012:

Average Annual Returns for U.S. Large Companies 1926-2012
(Nominal Returns – Not Inflation Adjusted)

Capital Appreciation	Dividend Returns	Total Returns
5.57%	4.31%	9.88%

Source: Standard & Poor's; Ibbotson

While these returns may seem modest, the compounding effect is truly remarkable. An investment of $1,000 in these U.S. large company stocks in 1926 would have produced a total of $3,630,134 by the end of 2012. To put this in a more contemporary context, an investment of $10,000 today in a Roth IRA (no taxes payable during the investment period or upon distribution) at a compound annual growth rate of 9.88% would produce the following market values when held one decade or longer:

The Power of Compounding

Investment	Holding Period	Market Value
$10,000	10 years	$ 25,656
$10,000	20 years	$ 65,822
$10,000	30 years	$ 168,873
$10,000	40 years	$ 433,257
$10,000	50 years	$1,111,559

Source: Bradley, Foster & Sargent

Thus, a 21-year old who invested $10,000 in a Roth IRA at a compound annual growth rate similar to the S&P 500 would have a portfolio worth $1.11 million dollars at the age of 71. This assumes, of course, that quality stocks during the next five decades perform as well as during the last 87 years – an assumption that we will analyze later. It also assumes that the investor stays fully invested in large capitalization equities through thick and thin – wars, impeachment trials, financial panics, attacks on America, bouts of inflation, recessions, and Great Depressions. Not always easy to do, but vital to achieve great returns.

The Importance of Dividends

It is noteworthy that for the 87 years between 1926 and 2012, returns from dividends (and the reinvestment of those dividends) of 4.31% accounted for more than 43% of the average annual return of 9.88%. Many investors believe that the best way to achieve excellent long-term returns is through investing in rapidly-growing technology companies, most of which pay either no dividend or modest dividends. Yet the preponderance of companies with the highest long-term (30 years and longer) returns are consumer staple and health care companies such as Philip Morris, Abbott Labs, Coca-Cola, and Procter & Gamble. Jeremy Siegel shows in his book, *The Future for Investors*, that Standard Oil/Exxon had a higher average annual return (14.42%) between 1950 and 2003 than IBM (13.83%) despite IBM's much greater price appreciation. Exxon's robust dividend of 5.19%, on average, made the difference. Until 1958, dividend yields on stocks were always greater than the yields on long-term government bonds. This was because investors demanded higher cash yields from stocks due to their greater perceived risk and volatility. Dividend yields remained smaller than bond yields for the following 50+ years until 2011, when the dividend yield on the S&P 500 again exceeded the yield on the 10-year U.S. Treasury note, which dropped below 2%. This shift back to dividend yields exceeding bond yields was caused primarily by the Federal Reserve's intervention into the bond market through what is known as QE2 and QE3. The following table shows the importance of dividends over the last eight decades:

Dividend Contribution to Total Return

Decade	Price % Change	Dividend Contribution	Total Return
1930s	-41.9%	56.0%	14.1%
1940s	34.8%	100.3%	135.0%
1950s	256.7%	180.0%	436.7%
1960s	53.7%	54.2%	107.9%
1970s	17.2%	59.1%	76.4%
1980s	227.4%	143.1%	370.5%
1990s	315.7%	116.7%	432.4%
2000s	-24.1%	15.0%	-9.1%

Source: Strategas Research Partners

Stock Market Behavior Since 1987

Some investors believe that stock market returns in the modern era differ from earlier days, and thus it is useful to review the performance of the stock market more recently. The table below tracks the S&P 500 operating earnings since 1987 and how the stock market valued these earnings:

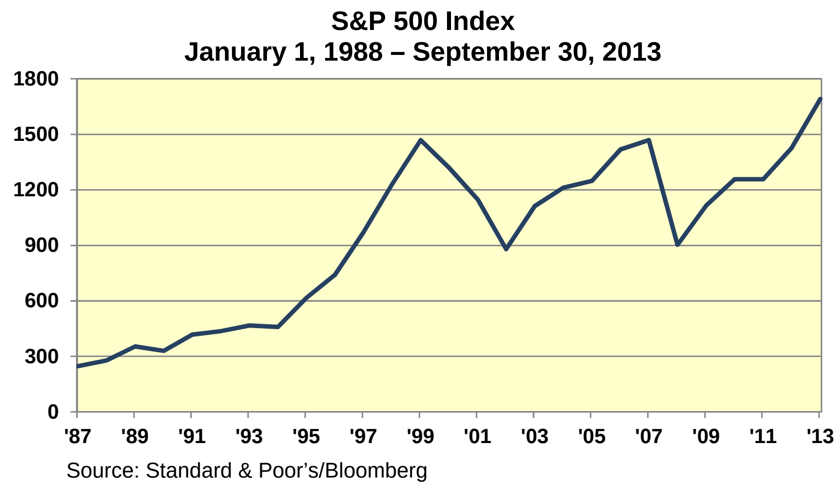
S&P 500 Earnings and Market Valuation (1987-2013)

Year-end	S&P 500 Operating Earnings	S&P 500 Index	P/E Ratio
1987	$ 16.04	247.08	15.4
1992	$ 20.87	435.71	20.9
1999	$ 51.68	1469.25	28.4
2007	$ 82.54	1468.36	17.8
2013	$110.51*	1690.50**	15.3

* 2013 year-end estimate
**October 4, 2013

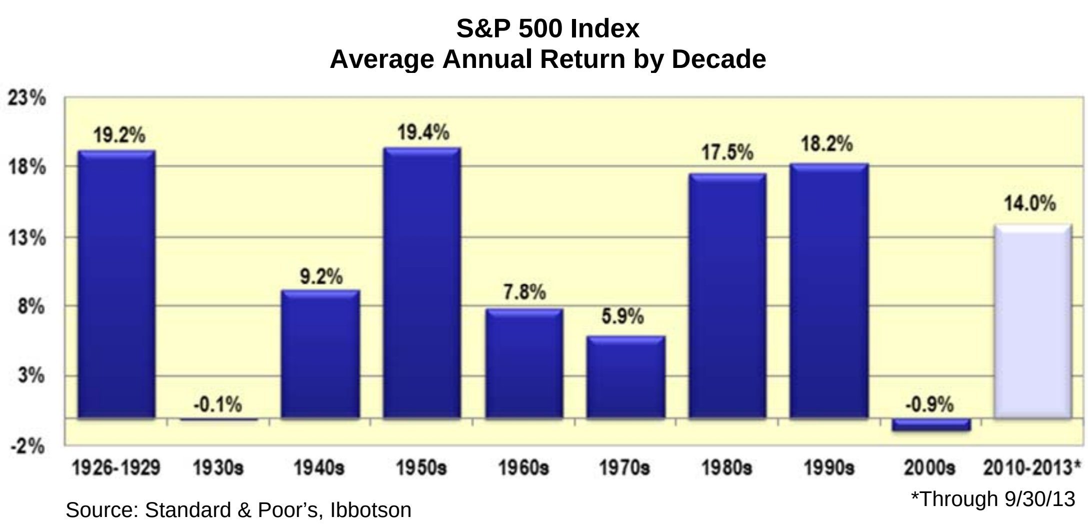
Source: Standard & Poor's/Bloomberg

The table on the preceding page clearly demonstrates the main reason for the terrible performance of the stock market during the past decade, as the market P/E ratio in 1999 – at the height of the Internet bubble – was a towering 28.4. This was the highest P/E in the history of the U.S. stock market and foretold the wrenching bear market of 2000-2002. It is also important to note that over this 26-year period, the S&P 500 operating earnings grew approximately 689%, while the S&P 500 Index increased 684% (the P/E today is nearly identical to the P/E ratio at the end of the Crash of 1987). Over long periods, stock prices track earnings very closely. From year-end 1987 through September 30, 2013, the average annual return of the S&P 500 was 10.04% – slightly greater than the compound annual growth rate of 9.88% from 1926 through 2012. The chart below demonstrates the trajectory of the stock market during this period, with strong performance until 1999 followed by a "lost decade" and the resurgence of the market over the past four years:



Stock Market Volatility

It is evident from historical data that the U.S. stock market over long periods of time, as well as since 1987, has produced average annual returns (nominal) of nearly 10%. But it is also clear that there have been periods of ten years and more where the stock market's cumulative total return has been negative. As the chart below shows, the decade from 2000 through 2009 had an average annual return of -0.9%:



Another way to track volatility and risk in the U.S. stock market is to analyze the distribution of returns for the S&P 500 Index since 1926. As can be seen below, there have been only 6 years of the 87 years during which the S&P 500 dropped more than 20%, and 5 years when it fell between 10-20%. In all, there have been 24 years out of 87 years during which the S&P 500 turned in a negative performance – roughly 28% of the time. The table below demonstrates how in the great majority of years, the stock market has been in positive territory (with 17 of the years showing a 10-20% gain and 32 of the years a 20%+ increase):

Distribution of S&P 500 Returns (1926-2012)

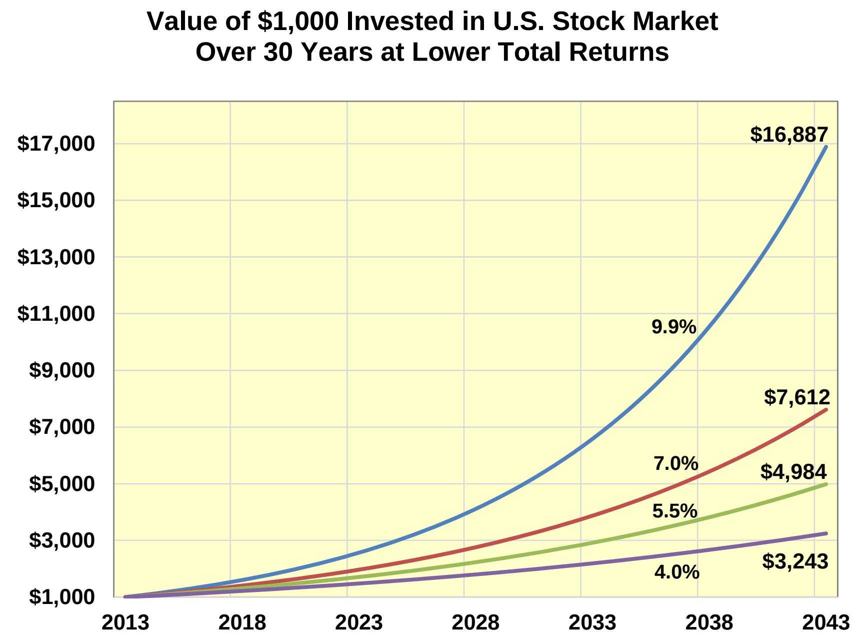
<-20%	-20% to -10%	-10% to 0	0 to 10%	10% to 20%	>20%
6 years	5 years	13 years	14 years	17 years	32 years

Source: Strategas Research Partners

Due to the volatility and unpredictability of the stock market, prudent investors understand that it is unwise to purchase stocks in the hope of earning solid returns over the short term. This is a game for speculators and traders. Most investment professionals recommend that the most appropriate time frame for investing in the stock market is ten years or longer. The investor who seeks to make enough money in a short period to buy a car or make a down payment on a house is asking for trouble. But over the long haul, the stock market has been a place where substantial wealth has been accumulated by millions of investors.

Will the U.S. Stock Market Produce These Historical Returns in the Future?

Over the past century, the price appreciation of the stock market has been closely correlated with the growth of corporate earnings. As the table on page 2 shows, the annual capital appreciation of the S&P 500 since 1926 has averaged approximately 5.6%. During this same period, corporate earnings in the U.S. have grown at about the same rate. The growth rate of corporate earnings is correlated closely, in turn, with nominal GDP growth. Nominal GDP growth (real GDP growth plus inflation) has been falling in the U.S. over the past several decades. While nominal GDP growth in the 1950s and 1960s often exceeded 6%, the average nominal GDP growth over the past 12 years has been less than 4%. Real GDP growth has averaged less than 2% annually during this period. Over the past decade, the U.S. has taken on many of the characteristics of European welfare states: Debt/GDP exceeding 100%, government spending representing a high and growing portion of the GDP, and higher taxes. This pattern in Europe and Japan has tended to produce lower economic growth, and it appears to be having the same effect here in the U.S. If this trend continues, it will likely mean nominal GDP growth in the U.S. of 4% or less, which will likely translate into lower U.S. corporate earnings over the intermediate term. Accordingly, it is a reasonable premise to project average annual price appreciation in the U.S. stock market of 3.5%-4% rather than the historic average of 5.6%. Currently the dividend yield on the S&P 500 is approximately 2%. Thus, the average annual return from the U.S. stock market could well fall from the 9.9% of past decades to 5.5% over the coming decades. If corporations were to increase the dividend payout ratio to augment the dividend yield from 2% currently to 3%, the market's total return annually might only fall to 6.5%. The chart on the next page chronicles what this could mean for stock market investors:



Summary

As things stand in Washington currently, there is little ground for hope that real U.S. GDP growth will re-attain its centuries-long annual average of approximately 3%. Growing entitlement programs and higher debt levels translate into lower economic growth, higher unemployment, and less corporate earnings growth. This, in turn, will likely reduce returns from the stock market in future decades. There are, however, two ways in which this scenario can be altered. The first is increasing globalization enabling quality U.S. companies to further penetrate foreign economies, producing greater revenues, earnings, and cash flow from abroad. This would lead to an ever larger percentage of S&P 500 corporations' earnings and profits sourced from faster growing economies abroad. World GDP over the coming years is projected to be at least 3.5% annually. As sales by foreign affiliates of U.S. corporations already account for approximately 40% of total sales, U.S. corporate earnings could grow faster than nominal U.S. GDP. The second reason for hope is that the American "experiment" in democratic capitalism has shown amazing regenerative powers over the centuries. Americans are generally pragmatic (although this seems to be lacking in Washington these days). There is still time to change U.S. political and economic policies and return America to a growth trajectory. In the meantime, our goal at Bradley, Foster & Sargent remains: to find, research, and invest in those quality companies, both here and abroad, with great brands, wide moats, strong balance sheets, and great cash flow. These companies are often able to exceed the stock market's total return over the longer term. Ownership of these great stocks should enable our clients to profit handsomely over the long haul. Our mantra is: time in the market – not timing it!