

Eads & Heald Investment Counsel

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Equity Investing

By: R. Stewart Eads, CFA

President

Eads & Heald Investment Counsel

www.EadsHeald.com

Chapter 1: Introduction

This series of articles will put forth some rather profound concepts that may well have a dramatic effect on equity investing as we know it. For starters there are three, and only three, components for the total investment return of any stock over any period of time. They are:

- Growth rate of earnings per share (percent per year)
- Dividend yield (percent per year)
- Change in the price to earnings (PE) ratio (percent per year)

Ultimately (say, over 30 years), stock prices go where earnings go. However, over the shorter term, PE changes can deflect the strict adherence of a stock price to its earnings growth. It will be argued that it is inflation, not interest rates, that serves as a key determinant of the long-term trend in stock PE ratios. That is, inflation is a discount rate for valuing the discounted present value of a future stream of corporate earnings. A stock price at any point in time is simply the discounted present value of future earnings per share. When investors are optimistic they tend to look out further in discounting. When they are pessimistic they look out less far. The belief in using inflation as the discount rate is based on a long history of empirical evidence (approximately 100 years worth). However, using inflation as the discount rate instead of interest rates is in direct contrast to conventional Wall Street wisdom. The other key long-term determinant of where stock prices go is, of course, the earnings growth rates.

It will be argued that a complete investment cycle in the U.S. has tended to be approximately 30 years in length. Linked to these concepts, it will be argued that it is possible to discern when one should focus on growth stocks and when one should focus on value stocks. It will be argued that the Standard & Poor's 500 stock index fund could be considered a cop-out for those investors without a clue as to what is going on in secular long-term style shifts between growth stocks and value stocks.

A "growth" stock investor in the 1972 to 1987 time period generally had poor returns when compared to investors in "value" stocks. More on the definitions of "growth" and "value" later.

The point will be made that the approximate 10% long-term (30 years) average annual compound rate of return for the U.S. stock market is made up of long periods where the market tended to average returns much better than 10% and long periods where it averaged returns much less than 10%. All of the above has very important implications for personal retirement planning models as well as for investing in general. Applicability of the ideas contained herein should run the gamut from the small individual investor up to the giant corporate retirement plan and college endowment.

By no means are these articles meant to be some sort of get rich quick scheme or to give the impression that successful long-term investing is easy. The intent herein is to help focus your attention on:

1. **Setting your long-term investment objectives to include both absolute and relative (to inflation, the overall stock market, etc.) return goals, risk tolerance and time horizons. Any special income needs or other special constraints should be included.**
2. **Outlining Future Investment Themes that you believe could have investment significance over the next five years.**
3. **Forecasting the future rate of consumer price inflation.**
4. **Forecasting the future earnings/share growth rates for the Standard & Poor's 500 stock index and individual companies in which you will consider investing.**
5. **Forecasting the trend of the price/earnings ratio for the Standard & Poor's 500 stock Index and for companies in which you might invest.**

In buying common stocks it is good to have as much going for you as possible. That is, as much as possible, use stocks with a good long-term record of earnings growing at a steady, consistent and healthy rate. As a general rule, stay away from new issues and turn-around situations. Stick with proven long-term consistent winners. Also, owning good stocks that you believe are riding a good Future Theme is advisable. Devising useful Future Themes is tricky, however. It is useful to reflect back on so-called themes that never worked out. Years ago, the oceans were going to be tapped for bountiful riches. Several decades later, this has not worked out as predicted other than maybe oil drilling.

Not to oversimplify, if you could predict the future earnings and dividend growth rates for a stock and gauge the trend in inflation (and thus price/earnings ratios) over the next several years, you would have what you need to determine your expected rate of return. If your time horizon was 30-35 years, the PE prediction would likely not be vital since the PE effect would have had a complete cycle and the stock price would probably follow the earnings growth.

There are a multitude of books out on investing in stocks and bonds. What could there be left to say? The focus here is on rudimentary concepts to help the investor have a much better understanding of the key determinants of stock price valuations over the long-term future. Much reliance is based on what empirical history has to teach us combined with logical ideas of why stock prices have done what they have done over time. The concepts expressed herein can be understood by anyone willing to take the time to reflect on them. There are no higher mathematics involved. Still, the concepts are profound.

Reading and understanding the ideas here will likely place you in the upper percentile of all investors in regards to understanding the stock market. You may even find you have a better understanding of the long-term workings of the stock market than your current financial advisors. The emphasis in these articles will be on "trends" -- thus, you will see the repeated use of ten year averages of data series. This is done to focus on longer-term trends and not year-to-year noise on which no one can predict or gain an advantage. It is riding the right trends in the overall stock market and in individual stocks that can make one very wealthy. Attempting to play the near-term gyrations in stock prices is generally a fool's game. An advisor might have recommended that you take your profit in Wal-Mart in the 1970's after you had doubled your money. "You can't argue with taking a profit". But, if you had held the stock for 35 years...wow!

U. S. equity investors are subjected to an overload of information, much of which is not productive for long-term investment success. The purpose of these articles is to discuss some rather simple concepts that are borne out in history and common sense. These concepts will not provide a certain road to riches in equity investing, but will allow one to focus energies on those endeavors that will be the most productive in the pursuit of success through equity investing. Some of the ideas put forth herein are rather profound and may well have a dramatic impact on equity investing as we currently know it.

This series of articles on investing will likely have very limited appeal for several reasons as follows:

- The focus is not about a coming worldwide economic debacle. Books on economic gloom and doom do very well. Query why?
- The articles are not a glib, easy to read treatise on how to make a quick killing by "playing the stock market." The shelves at leading bookstores are already full of such books.
- The articles address a multitude of boring topics such as setting your long-term investment objectives, historical rates of return from investing in stocks, bonds and other investments, which investment style to select and other fundamentals important for success.

The items addressed herein are simply not what sells books to the masses. The purpose here is to appeal to the limited audience of intelligent, thinking investors -- the type investors not easily separated from their money.

The articles are somewhat of a maverick in that they are not about arcane academic theories at the one extreme, nor are they shallow and frivolous at the other extreme. They obtain a lot of their basis from empirical history and are very heavy on applied common sense gleaned from forty years in the investment business. Investment geeks are not cool. Colorful, loud talking prophets are fun to watch.

Beginning in the late 1970's I began predicting that the big news in the decade of the 1980's would be a dramatic drop in the high rate of inflation we had seen throughout much of the 1970's. Further, I predicted that this would cause the price/earnings ratio for common stocks to expand for the period 1980 on into the 1990's. I predicted that the average annual rate of return from investing in stocks from the early 1980's to the mid-1990's would be in the vicinity of 18-20% per year. This was very close to the actual results. My then associates at Wellington Management Company, and anyone I could get to listen, heard all of these predictions ad nauseam.

Citing the above is not to glorify myself, but only to make a very important point. Much of the fame and fortune made by some people on Wall Street often has nothing to do with making correct

predictions or actually making money for clients. Unfortunately, as we have all learned over the past few years, some fame and fortune on Wall Street is garnered by going outside the law. Other fortunes are made by people in the business who are aggressive, charismatic salesmen -- actual investment results for clients often has very little to do with it. There are economists, strategists, market technicians and others who can pack ballrooms full of eager listeners even though their long-term forecasting records may be abysmal. Being a great speaker with charisma can sometimes overcome the annoying small stuff. Oftentimes, it is not even clear what their long-term record has been. How do you track the successes/failures of a stock market technician? Who measures their performance record? Who measures the performance record for an economist or for a stock market strategist? Who measures the investment success of brokers at the large stock brokerage firms?

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