

Eads & Heald Investment Counsel

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Equity Investing

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Chapter 11: Stock Prices Ultimately Go Where Earnings Go

Ultimately, stock prices go where earnings go. Chart 1 shows the trend in Standard & Poor's 500 price and earnings. Inflation is also shown. Running 10 year averages are used and the values are all indexed to 1.0 at the start. The running 10 year averages allow us to focus on the underlying trends and not have our focus diverted by short-term noise in the data.

Note that after over 100 years stock prices continue to track along with earnings. Both prices and earnings gradually pull away from inflation. You see that as inflation inflects upward, the price tends to move up slower than earnings. This is a period of PE contraction per Chart 1 in Chapter 10. When inflation slows down, the price tends to move up faster than earnings. This is a period of PE expansion per Chart 1 in Chapter 10. Nonetheless, over this very long time period displayed price and earnings keep coming back together and price ultimately goes where earnings go.

Chart 2 shows a year-to-year picture of earnings progression and inflation since World War II. A trend relationship between earnings and inflation can be discerned as with the prior 10 year moving average chart. As inflation increases from the mid 1960's through the 1970's, the trend in earnings growth also increases. As inflation slows down beginning in the early 1980's, the earnings trend also slows down. Still, Chart 1 using 10 year moving averages makes it much easier to view trends as the short-term noise is smoothed out.

The message here is simply that over the long-term stock prices will go where earnings go. However, over the short and intermediate term inflation will cause price-to-earnings (PE) ratios to trend up and trend down. Thus, earnings and price gradually move above and below each other over time. Increasing inflation tends to result in declining PE's while declining inflation typically sees a period of rising PE's. The key is for long-term investors to own a very diversified (35 or more) stocks and monitor them to weed out those with decaying trend fundamentals. Shorter term market, or individual stock, timing/trading never makes sense.

Over time periods of 15 or so years there may well be an opportunity to be in the type stocks that will most benefit from either a declining or rising trend in inflation. In short, growth stocks typically benefit from long periods of declining inflation and rising PE's. More on this later.

Chart 1

Wealth Indices - 10 Year Moving Average

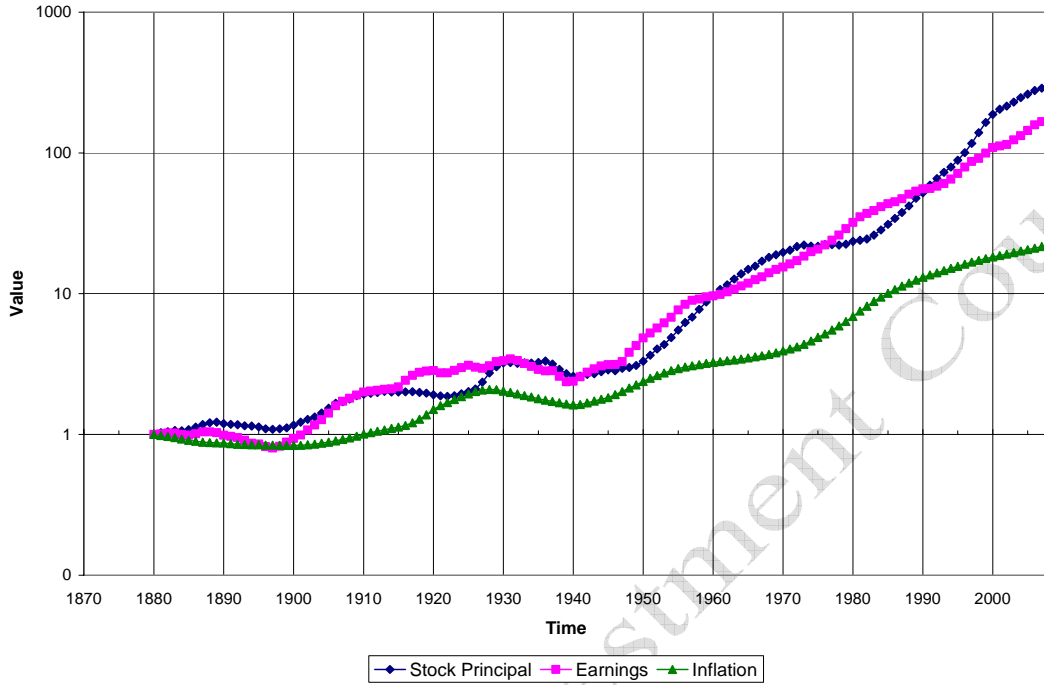


Chart 2

S&P 500 E.P.S. and CPI Cumulative Index

