

# Eads & Heald Investment Counsel

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## Equity Investing

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### Chapter 13: A Computer Generated Fair Value Channel

Back in the early 1980's while at the Wellington Management Company, I put forth my first Fair Value Channel. It was a channel with a dramatic rise through the 1980's and on into the 1990's as I expected inflation to peak soon and for a major PE expansion to take place. The staff at Wellington heard my views on this ad nauseam. I was forecasting the S&P 500 to return 18-20% per year on average in the 1980's and reach a level of 520 by the end of 1994. The S&P 500 generally met these expectations for rate of return in the 1980's and 1990's. My predictions were more on track than most of the seers on Wall Street. The Fair value Channel is not a road to riches. However, it does allow one to focus on two key variables in a trend sense.....earnings growth rates and inflation.

I have continued the concept of the Fair Value Channel and eventually turned it into a computer model. Chart 1 is a Fair Value Channel generated by a computer using earnings growth rates and inflation as the only inputs. The channel width is always kept constant. The solid-colored area is the actual high/low of the S&P 500 each year. This computer generation has done an excellent job of capturing the general trend directions of the stock market over a 68 year time period. To forecast the channel direction going forward, one needs to input projections of trend PE and the S&P 500 earnings growth rate. I believe that the trend in PE is directly determined by the trend in inflation. Thus, in the computer model, the direction of the channel is determined by projections for the earnings growth rate (S&P 500) and inflation. This particular model run assumes that earnings growth returns to the trend growth rate of the period 1940 through 2007 by the end of 2010 and then grows at 6.5% per year through 2020. Inflation is projected at 1.0% for 2009 and then 3% per year out through 2020. Chart 2 shows an index for S&P 500 earnings per share with the focus on 1940 through 2020. The years 2009 through 2020 inclusive are estimates. Note how 2010 through 2020 grows at approximately the same rate as 1940 through 2007.

Earnings growth and PE change are combined in a multiplicative process to arrive at the channel's rate of change:

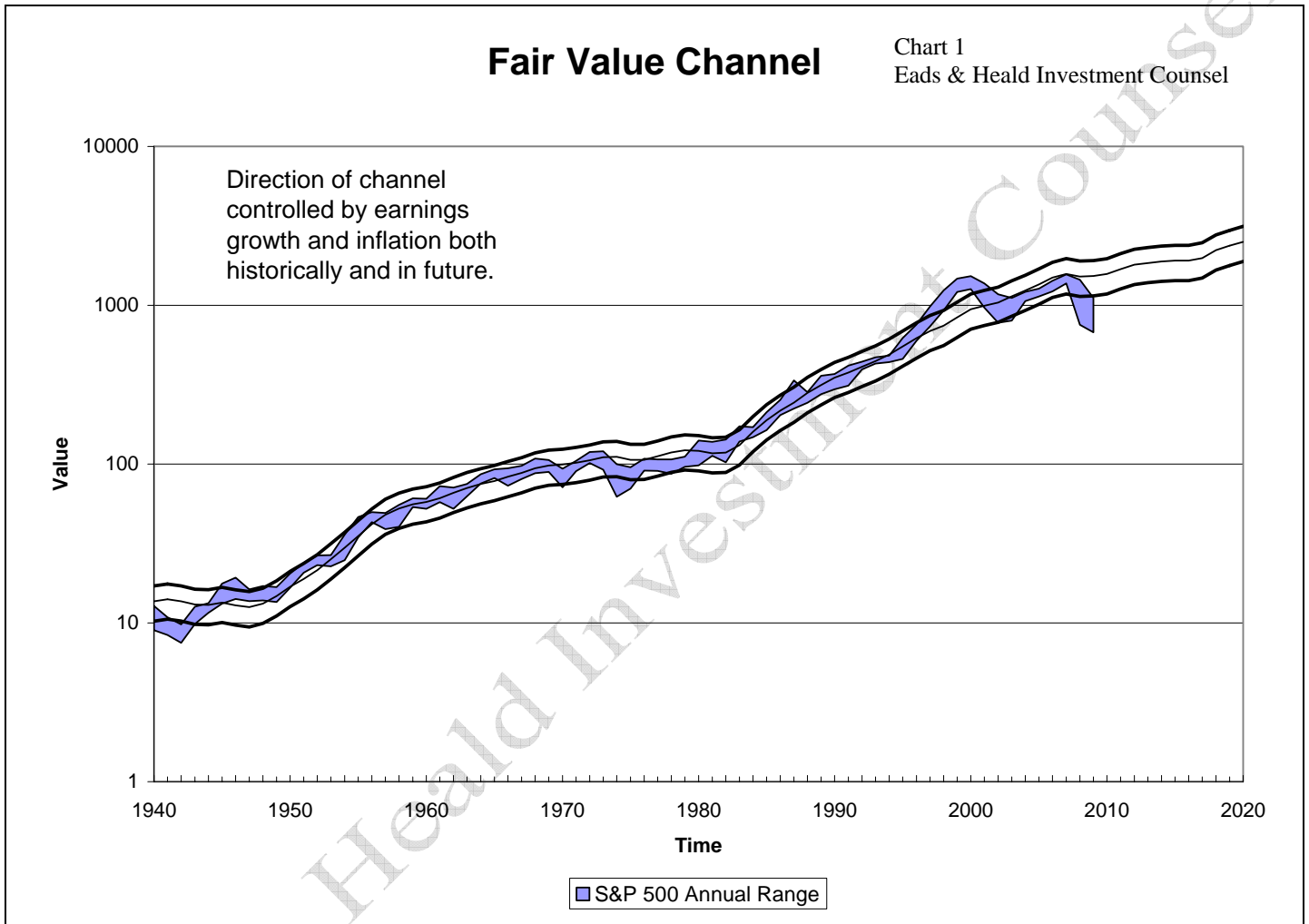
$$(((1 + g/100) * (1 + PE/100)) - 1) * 100\%$$

where  $g$  = Earnings per share growth rate and  $PE$  = Average annual change in PE

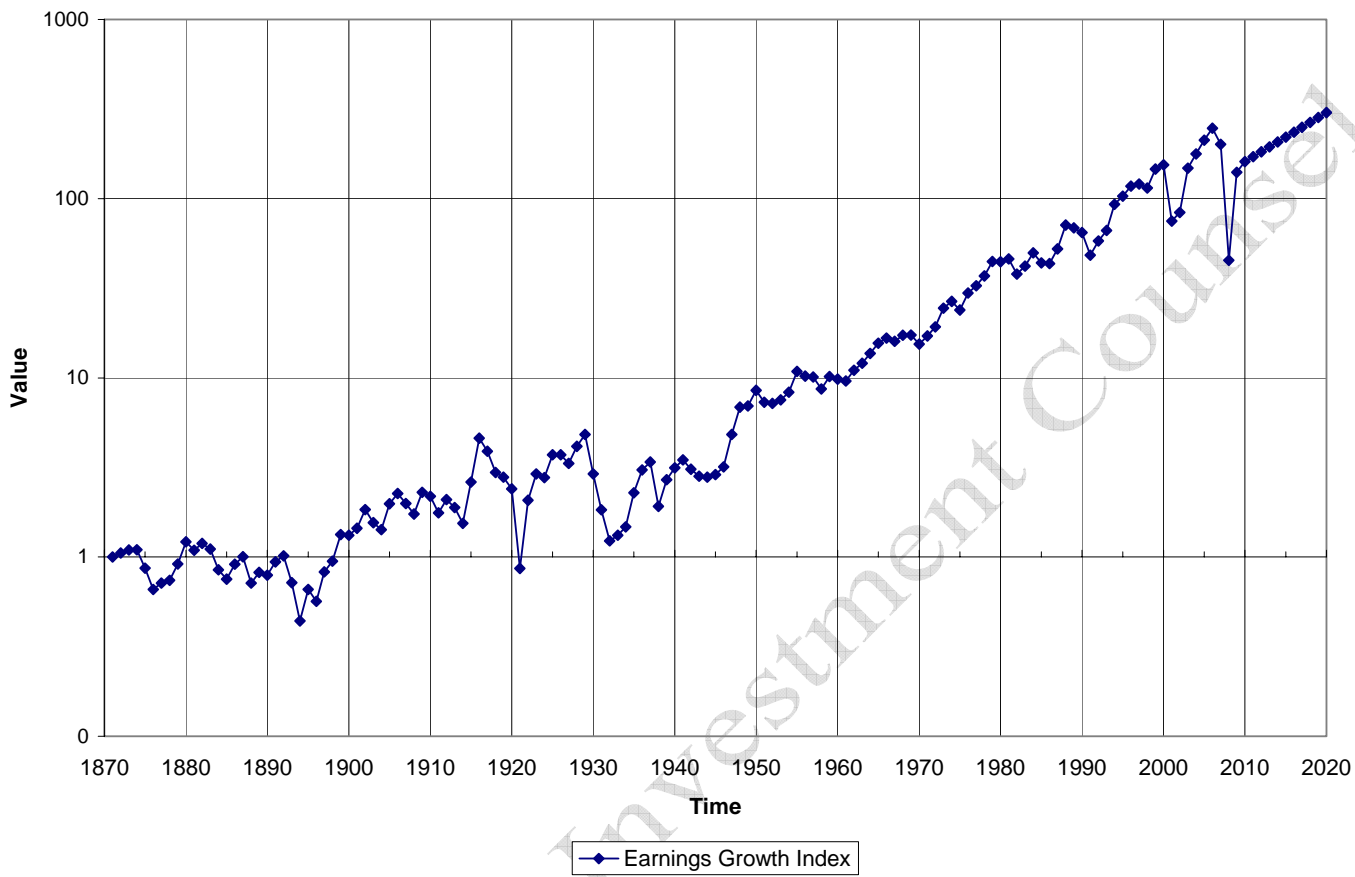
The resulting product represents the trend movement in the channel's direction. Internal in the model is a quantitative relationship between PE and inflation so that the direction of the channel is ultimately only driven by the earnings growth rate and inflation.

I believe that short-term micro market timing is essentially impossible. I do believe that trend market forecasting is very achievable if one focuses on predicting the future trend in inflation and earnings growth.

Given that the large pools of investment money are, or should be, very long-term by nature, this work could be truly dramatic. Individual investors should also focus on the longer-term, but the likelihood is that only a very small percent of individual investors will stay on a successful long-term course. Current wish-list spending and/or chasing the latest year's hot investment style will generally derail their quest.



**S&P 500 Earnings Growth Index** Chart 2  
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