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Defending the Trend

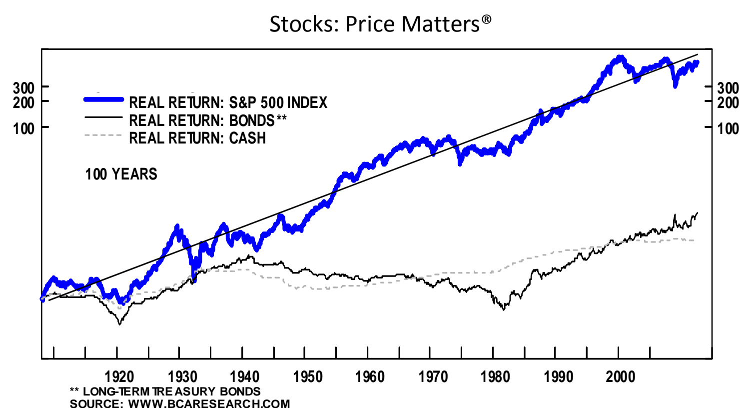
"The cult of equity investing is dying," Bill Gross argues in PIMCO's August investment outlook, claiming investors should not expect the 6% to 7% long-term inflation-adjusted returns that equities have historically provided. We are tempted to limit our response to these assertions to the simple observation that PIMCO's actions usually speak louder than their words — PIMCO has launched six equity investment products since first entering this market in mid-2010. However, we disagree with so many of the points raised by Mr. Gross that we think RiverFront's investors deserve refutation of his analysis.

Bond Returns — Yield Matters

Mr. Gross opens his piece with the observation that bonds have outperformed equities for much of the past 30 years, supposedly undermining the notion that equities' higher risk will be rewarded with higher long-term returns. He neglects to mention that stocks posted double-digit returns during that same 30-year period, a level of return that in no way undermines the 6%-7% long-term trend for real returns. Stocks failed to outpace bonds over the last 30 years because long-maturity US Treasuries offered yields of nearly 15% in 1982. That unprecedented yield produced a return that is mathematically impossible to reproduce given the current yield of 2.54% for the 30-year Treasury bond.

Stock Returns — Price Matters®

Mr. Gross contrasts bonds' attractive returns to the disappointing returns of stocks over the past 10 to 15 years, extrapolating this poor performance to suggest that stocks' long-term trend of 6%-7% real returns is "fading." Mr. Gross defends his assertion using the same long-term trend analysis that forms the heart of RiverFront's Price Matters® discipline. Our interpretation of that data is that a historically high starting price, rather than a fading trend, explains the disappointing equity returns over the past 10 to 15 years.



We reproduced the chart Mr. Gross used in his outlook (with permission from BCA Research). As shown in that chart, by the late 1990s equity prices had been inflated by a speculative bubble to nearly 100% above the long-term 6% to 7% trend. Similar

bubbles in the 1920s and 1960s resulted in approximately 10 to 15 years of depressed equity returns. These protracted bear markets occur because it takes more than 10 years for the trend to catch up to such extreme overvaluations.

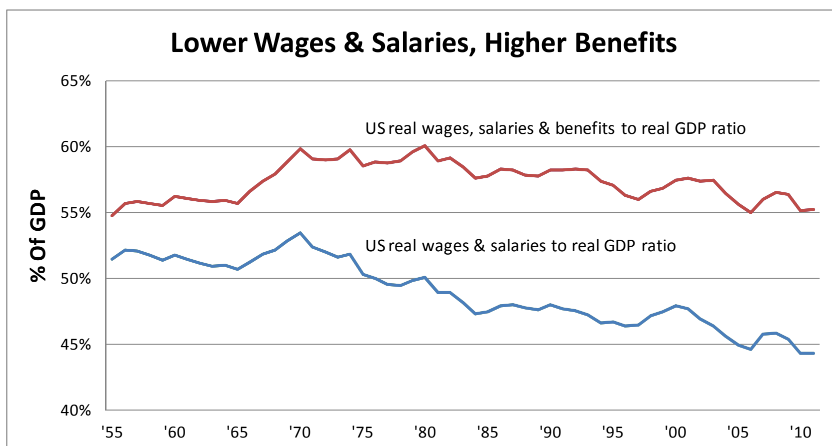
Equity bulls in the late 1990s were wrong to believe that the decade's inflated returns signaled an acceleration of the long-term trend, and we believe it is similarly wrong to interpret the poor equity performance since the late 1990s as proof of a deceleration. A decade of below-trend returns (the 2000s) offsetting a decade of above-trend returns (the 1990s) strikes us as a confirmation, not a refutation, of the long-term 6% to 7% trend.

Stock market gains have not come at the expense of workers (they've come at the expense of bond investors)

Mr. Gross supports his contention that long-term equity returns are decelerating by suggesting that the historical 6% to 7% trend is a result of a "Ponzi scheme." With long-term economic growth averaging 3.5%, Mr. Gross says that equity returns of nearly twice that amount have been at the expense of labor. He notes that, over the past 40 years, wages and salaries as a percentage of GDP have dropped to about 44% from about 51%. According to Mr. Gross, by shifting an increasing amount of the economic pie to corporations, equity returns have been artificially and temporarily inflated.

Mr. Gross accurately cites the decline of real wages and salaries as a percentage GDP, as shown in the adjacent chart. However, our chart also displays the historical trend of wages, salaries and benefits since the 1950s. **Worker compensation as a percentage of GDP is about the same today as in 1955 when retirement and healthcare benefits are included.** However, a much larger share of compensation comes from benefits (especially health benefits) compared to 50 years ago.

As evident in the long-term return chart for stocks and bonds on the previous page, bond investors provided capital to our economy yet received no return relative to inflation for most of the past 100 years (note the flat line of real bond returns from 1900 through the early 1980s). **Equity returns were subsidized not by labor but by bond investors' willingness to forgo a real return on their investment in exchange for the perceived safety of their bonds, in our view.**



Source: Bureau of Economic Analysis.

Bond investors' complacency was shattered by 1970s inflation and, more directly, by bonds' severe losses when the Federal Reserve raised rates to fight that inflation – an index of 30-year Treasury bonds' inflation-adjusted total returns fell by more than 50% from 1972 through September 1981. Thus, for much of the past 30 years bond investors have demanded and received higher interest rates than was typical for most of the past 100 years. These high real interest rates suggest that equities were not subsidized during this period. However, increasing globalization made global GDP growth a more important driver of equity returns than US GDP growth, and emerging economies (especially China and India) were entering a period of extraordinary economic growth. Although emerging economies are unlikely to repeat the breakneck economic growth of the

past 30 years, low interest rates (shown in the table below) suggest that bond investors are once again willing to subsidize equity returns.

COMPANY	AS OF/ISSUE DATE	5-YR BOND COUPON	10-YR BOND COUPON	30-YR BOND COUPON
US Treasury	8/1/12	0.64%	1.52%	2.60%
Bristol-Myers Squibb Co. (BMY-N)	7/26/12	0.875%	2.00%	3.25%
3M Co. (MMM-N)	6/21/12	1.00%	2.00%	
Monsanto Co. (MON-N)	7/15/12		2.20%	3.60%

Source: Bloomberg

At current prices, we believe equities provide a margin of safety against inflation

Mr. Gross concludes his piece with a point that we have made often – developed economies are likely to solve their debt problems by printing money until their debt is inflated away. To quote Mr. Gross, "the cult of inflation may have only just begun." While we agree that inflation is a real possibility over the coming decade – and "woe to the holder of long-term bonds in the process" – we disagree with Mr. Gross' assertion that "stocks … perform poorly as well in inflationary periods."

Investors typically associate rising inflation with equity losses because stocks performed poorly in the most recent inflationary period in the US — the late 1960s and 1970s. However, our analysis suggests that equity returns during high-inflation periods depend on starting valuations. Thus, the 1970s losses were predominately a result of stocks starting as much as 85% above their long-term trend following the equity market bubble of the 1960s. Inflationary periods that began with extreme levels of overvaluation (1965-1975 and 1970-1980) saw depressed nominal returns and relatively severe losses relative to inflation, as shown in the table below. By contrast, **periods starting after prices had fallen enough to correct the overvaluation (1938-1948, 1941-1951, 1974-1984 and 1976-1986) had high nominal returns and positive real returns despite high inflation.** In our view, prices paid for equities have a greater impact on real returns than the inflation environment. With most equity asset classes currently priced well below their long-term trend, we believe that equities are priced to provide positive real returns even in a 1970s-style severe inflationary environment.

Distance from trend has greater impact on large-cap stock returns than inflation

	Distance From Trend	Annualized CPI	NominalAnnual Return	Real Annual Return	Real Cumulative Return
1938-1948	-20.00%	5.00%	9.30%	4.20%	50.00%
1941-1951	-21.00%	6.10%	13.10%	6.90%	95.00%
1965-1975	84.60%	5.20%	0.80%	-4.30%	-35.60%
1970-1980	38.10%	7.40%	5.10%	-2.20%	-19.80%
1974-1984	5.70%	8.20%	9.20%	0.90%	9.70%
1976-1986	-24.80%	7.00%	13.60%	6.10%	1.60%

*Source: RiverFront Investment Group and CRSP**
** Calculated based on data from CRSP 1925 US Indices Database ©2012 Center for Research in Security Prices (CRSP®), Graduate School of Business, The University of Chicago.*

Debt Matters — A Point of Agreement

The BCA Research chart (on page 1), depicting the long-term trend of equity market returns shows that the market seldom hugs along the trend line and spends long periods either above or below the long-term trend. The historical "below trend" periods tend to correspond to times when the US economy is plagued by high debt levels and the inflation or deflation associated with those debt levels.

Normal economic environments that begin with equity markets well below the long-term trend line usually produce above-trend returns as markets "mean revert" toward the trend. However, the debt burdens plaguing the US and other developed economies suggest that we are once again in for an extended period of undervalued markets, and **we will probably have to wait until debt issues have been resolved to experience another extended period of above-trend returns**. Equity markets from historical periods of below-trend valuations produced average 10-year returns of about 5% over inflation, and that forms the basis for RiverFront's expected return calculations. By contrast, Mr. Gross predicts nominal returns of only 4% (we are not sure how this number was derived) and any inflation would have to be deducted from this figure.

Conclusion – it's not different this time

Bill Gross is one of the greatest bond investors of all time, in our view. However, his analysis of equity returns repeatedly fails to account for starting valuation levels. We believe this analytical oversight leads him to underestimate potential equity returns, just as investors' similar failure to account for starting valuation levels led to overly optimistic equity return expectations in the 1990s.

We defend equities' long-term 6% to 7% trend for the same reason it has persisted for the past 140 years: high long-term inflation-adjusted returns are required to entice investors into the volatile "cult of equity investing." Absent government intervention, we think companies will cut expenses, improve productivity, sell into faster growing emerging markets and, if all else fails, go out of business until the survivors achieve this required rate of return. For all the problems facing the global economy, we believe this fundamental driving force behind equity returns remains intact.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Standard & Poor's (S&P's) 500 measures the performance of 500 large cap stocks, which together represent 75% of the total US equities market. It is not possible to invest directly in an Index. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future.

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RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.