Where Do You Look For Return Now?

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Does This Tell Us Anything?
Dividend Yield

A Perfect Storm? How the Next Quarter-Century May Differ from the Last
What Does This Tell Us?

**Earnings Yield**

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S&P500 Stock Earnings Yield (%)
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**Attributing Return**

<table>
<thead>
<tr>
<th></th>
<th>76 Years, Starting Dec. 1925</th>
<th>Prospects from May, 2002</th>
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<tbody>
<tr>
<td>Starting Dividend Yield</td>
<td>5.1%</td>
<td>1.4%</td>
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<tr>
<td>Growth in Real Dividends</td>
<td>1.3%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Change in Valuation Levels*</td>
<td>1.1%</td>
<td>** ? **</td>
</tr>
<tr>
<td>Cumulative Real Return</td>
<td>7.5%</td>
<td>3.4%±</td>
</tr>
<tr>
<td>Less Starting Bond Real Yield</td>
<td>3.7% (a)</td>
<td>3.3% (b)</td>
</tr>
<tr>
<td>Less Bond Valuation Change**</td>
<td>-0.8%</td>
<td>** ? **</td>
</tr>
<tr>
<td>Cumulative Risk Premium</td>
<td>4.6%</td>
<td>0.1% ±</td>
</tr>
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</table>

(a) A 3.7% yield, less an assumed 1926 inflation expectation of zero.
(b) The yield on US government inflation-indexed bonds.
Yields went from 5.4% to 1.4%, representing a 2% annual increase in the Price/Dividend Valuation Level.
** Bond yields went from 3.7% to 5.8%, representing a 0.4% annualized drop in long bond prices; real yields on reinvestment were also poor during much of this span.

*Based on Ibbotson data*
Where To From Here?

- **Equity Risk Premium**
  - Will Be Lower Than What Investors Expect

- **Valuation**
  - Still High by Historical Standards

- **Earnings Quality**
  - Lower Than What Investors Have Believed?

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Equity Investing

- **Core Equity Management**
  - **Past:** Marginal underperformance somewhat more tolerable when equities were returning 15-20% and more
  - **Future:** Alpha is much more important, especially when equity returns are negative

- **Market Neutral Equity Management**
  - **Past:** Best if alpha was ported back to equities, so removing the market exposure was less important
  - **Future:** The role of equities in generating alpha without market exposure is far more attractive in this environment.
The Conventional, Unconventional Source of Return

- **Absolute Return/Hedge Fund Strategies**
  - Past: Great Alpha, Uncompetitive Returns
  - Future: Alpha adds to spendable returns. Look for negative correlations with major asset classes

"Nobody goes there anymore; it's too crowded."
– Yogi Berra

“Uncrowded” Sources of Return

- **Macro-oriented Hedge Funds**
  - Past: Focused on unique (i.e., unrepeating) sources of value added (e.g., Soros, Robinson)
  - Future?: Focused on exploitation of recurring market inefficiencies as is often done in stock selection

- **Active Currency Management**
  - Past: Simply hedging foreign equities would have worked well for US investors
  - Future: Removing the hedge makes sense from a US dollar perspective, but with an expensive pound sterling, this will only work if selective hedging is in place.
“Uncrowded” Sources of Return

- **Tactical Asset Allocation**
  - **Past:** Episodic returns, large alpha
    Couldn't match roaring bull market
  - **Future:** In see-saw markets, no asset class dominates
    In turbulent markets, TAA is at its best

- **Rebalancing**
  - **Past:** Boosts risk-adjusted returns, but costs money
  - **Future:** Boosts returns

**Summary**

- **Equity Risk Premium Will Be Lower**
- **Marginal Value Added Matters More**
- **Look For Value Added Where Others Don’t**
"There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."

John Kenneth Galbraith
A Short History of Financial Euphoria