THE LOST DECADE

A Greenspring Wealth Management Research Report

AUGUST 2008

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INTRODUCTION

The first decade of the new millennium is shaping up to be one we should soon hope to forget. After 8 ½ years the US stock market, measured by the S&P 500, has generated a meager average annual rate of return of 0.06 percent. That's not a typo. Essentially, the broad stock market has produced no returns, even after dividend reinvestment. Many of you may have heard the old saying to invest for the "long-term", but we are getting into the territory of, "How 'long' do I need to wait?" Is it time to call it quits on stocks in favor of other types of investment like bonds, real estate, hedge funds, or commodities?

It is with this backdrop we decided to perform some internal research on stock market returns in the United States over the past century, in order to lend perspective on our current struggles and guidance on possible future outcomes. While we do not know what the future holds, we have always found it valuable to review the past, in order to help us evaluate the future.

EVALUATING THE PAST

E.S. Browning, a journalist from the Wall Street Journal, coined this period as "The Lost Decade" and we felt like it was especially appropriate given the data in Table 1. This table summarizes the data taken from rolling ten year periods on the S&P 500 over the past 81 years. While the S&P 500 only returned about half of its average annual return during most recent ten year period, ending December 2007, the real problem will be the upcoming ten year periods. To put these approaching time periods in perspective, if the market stays stagnant for the next 1 ½ years, the first decade of the century would rank as the fourth worst ten year period since 1926 (the three other periods all occurred during the Great Depression). For "long-term" investors, pensions and endowment funds counting on equity returns to mimic their historical averages, the last decade has proved to be especially troublesome.

TABLE 1: ROLLING 10 YEAR PERIODS OF THE S&P 500 FROM 1926-2008

	Average Annual Return	Period covered
Best Period	20.06%	1949-1958
Worst Period	-0.89%	1929-1938
Average Period	11.09%	N/A
Most Recent Period	5.91%	1998-2007
Current Decade (8.5 yrs)	0.06%	2000 - 6/2008

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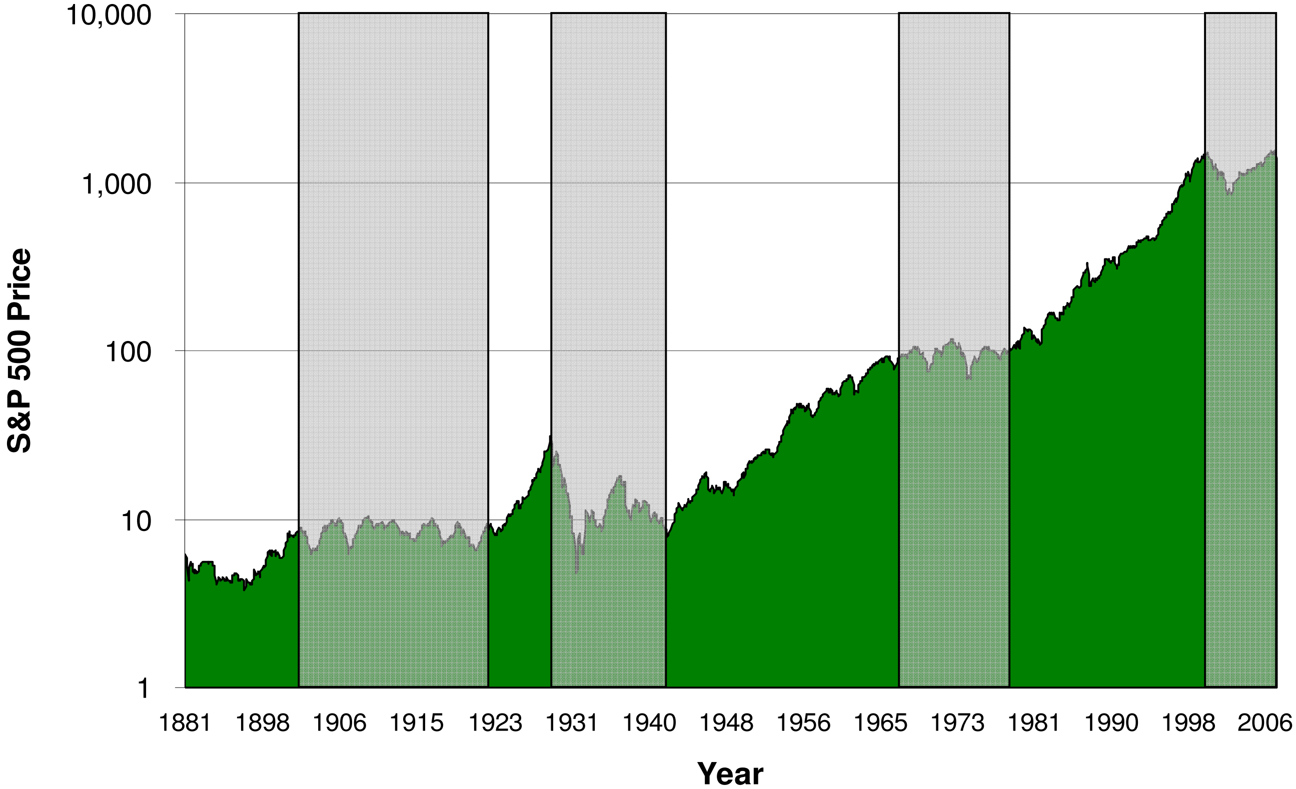
CHART 1: HISTORICAL PERFORMANCE AND "RANGE BOUND" PERIODS OF THE S&P 500 FROM 1881-2007



Data Source: Robert Shiller, Yale University- Irrational Exuberance

LONG-TERM PERSPECTIVE

Interestingly, this phenomenon of low returns is not uncommon. After every major bull market in the United States, there has been a "cooling off" period. During such times, the markets tend to move sideways for a certain period. As Chart 1 shows, the US has experienced several "sideways" markets since the late 1800s. These periods, termed "range bound" markets are shaded in gray. Every one of these periods immediately followed a fairly prolonged bull market.

While the circumstances in each one of these time periods were different, the performance of the equity markets are always driven by some constant factors. History tends to repeat itself and this time does not seem to be any different than the past.

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HISTORY REPEATS ITSELF

So what has caused this stagnation we have seen the past 8 ½ years? When we look at long-term stock returns, they are driven by three factors- dividends, earnings and valuation. Let's look at each of these factors both in 2000 and today:

TABLE 2: STATISTICS FROM THE S&P 500

	2000	2008[1]	% Change
Price of S&P 500	1469	1280	-12.9%
Dividend Yield	1.14%	2.24%	96.5%
Operating Earnings per share	$51.68	$72.21	39.7%
Price to Earnings Ratio	33.97	17.76	-47.7%

If you were to just look at the dividend yield and operating earnings of the companies in the Table 2, you would almost have to believe that the S&P would be trading higher in 2008 that it was in 2000. With dividend yields almost double and earnings nearly 40 percent higher in 2008 than in 2000, the logical assumption would be higher stock prices. Not so fast. These last 8 ½ years have been a great example of how valuations can effect stock prices. So, while the operating companies of the S&P 500 have experienced tremendous strides since the turn of the century, their share prices have fallen nearly 13 percent!

The reason rests solely on how the market values a stock. A company is typically valued by the amount of earnings it will generate for the foreseeable future. Most rational investors are willing to pay more for a company (or group of companies such as the S&P 500) that is expected to generate growing earnings. The metric that is often used to determine the value of a company is the Price-to-Earnings Ratio (P/E). The larger the ratio, the more an investor is willing to pay to own the expected stream of earnings from the company (i.e. the more expensive the company is to buy).

VALUATIONS MATTER

If we look back on 2000, investors were willing to buy a stock at almost thirty-four times its earnings. This is almost double the average valuation of the stock market over the past 80 years. If you can remember back to 2000, it was a period of euphoria. People were willing to buy a company at any price, regardless of the true value of that company. This dramatic increase in valuations is shown in Chart 2. Over the past fifty years stocks had never been so expensive, when valuing their price to their earnings. The unwinding of these valuations was a major reason the market collapsed during the first few years of this decade.

[1] As of 6/30/2008

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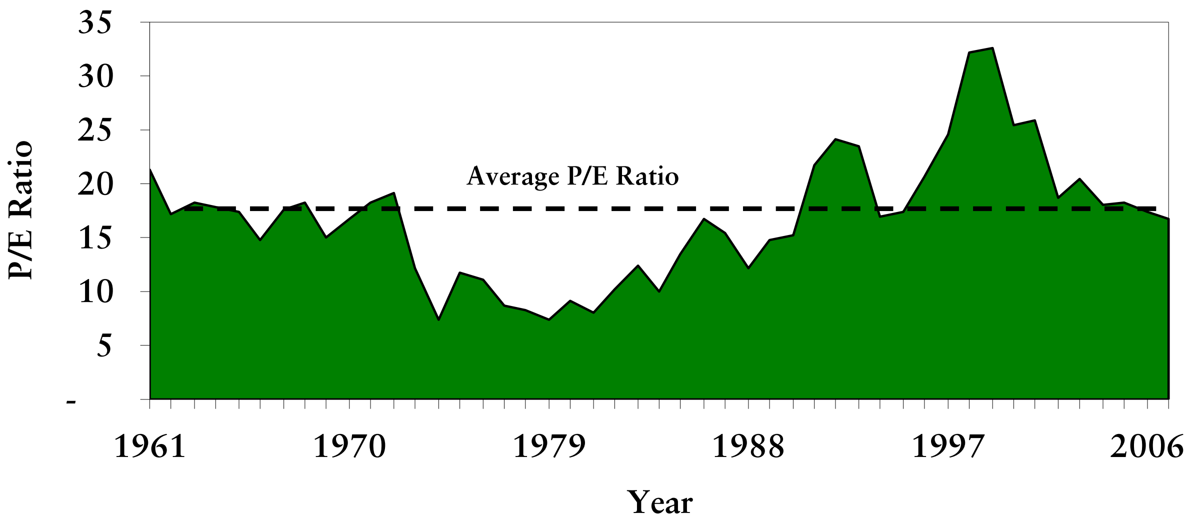
CHART 2: PRICE-TO-EARNINGS RATIO
OF THE S&P 500 FROM 1961- 2007



LOOKING FORWARD

So what we saw from 2000 to 2008 was not underperformance of the companies held in the S&P 500, but a change in the way the market valued these companies. As a whole, the companies are performing much better today than they did back in 2000. The reason that their stock prices are lower today, is that people are not willing to pay as much for their earnings stream. Chart 3 discusses the future returns of the S&P 500 when an investor purchases the index below or above a P/E ratio of 17, the long-term historical average

What is quickly apparent is that the valuation of the stock market when you invest has a dramatic impact on your overall long-term returns. Investing when the market is below its historical average assures investors of less risk due to valuation compression

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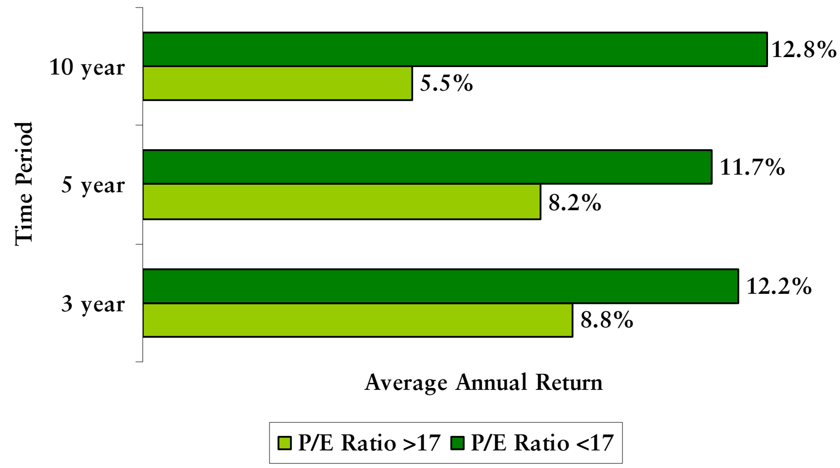
CHART 3: FUTURE RETURNS WHEN INVESTING IN THE S&P 500 AT DIFFERENT P/E RATIOS (1961-2007)



SILVER LINING

As we approach a new decade, investors can take comfort in the following thoughts:

- After every "range-bound" market, the S&P 500 has retraced its losses and gone on to higher prices

- The S&P 500 is 8 ½ years into a range-bound market, during which the average company has increased their dividend and grown their earnings significantly.

- The S&P 500 is hovering right around its long-term historical P/E ratio average of 17, meaning that the market is not significantly overvalued (from a historical context).

- A diversified portfolio can significantly outperform the US equity market. For example, over the past ten years, a portfolio consisting of an equal weighting in Large Company Stocks (S&P 500), Small Company Stocks (Russell 2000), International Stocks (MSCI EAFE), Real Estate (Wilshire REIT), and US Bonds (Lehman Aggregate Bond) would have returned 8.47 percent, versus 5.91 percent for the S&P 500. Also, during the last 8 ½ years when the S&P 500 returned a dismal 0.06 percent, this diversified portfolio achieved a 6.62 percent average annual return.

Long-term investing is not dead. While range bound markets can present significant challenges, disciplined investors recognize they have always been the preamble to the next great bull market.

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