

INSIGHT & OUTLOOK

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Burke, Nehru and the Art of Forecasting

Edmund Burke on Forecasting

Edmund Burke (1729-1797), the great Irish-born British statesman and conservative political writer, wrote “You can never plan the future by the past.” That was good advice for the King’s ministers and it remains good advice today—especially for brave souls attempting to forecast the multifaceted financial markets. This quarter we are going to tackle one of the thorniest questions in investments, “What is a reasonable return to expect from stocks over the remainder of this decade?”

The Expected Return from a Single Stock

Let’s begin with a hypothetical company whose stock is trading at \$100 per share, with earnings per share (EPS) of \$4.00 and a dividend of \$1.00. The stock’s price to earnings ratio (P/E) is $\$100/\$4=25x$. Its dividend yield is $\$1/\$100=1\%$.

Let’s assume the company’s shareholders’ equity per share (also known as its book value per share) is \$25 so it is earning a return on equity of $\$4/\$25=16\%$. Theoretically this company can grow its earnings at a 12% rate because it is earning 16%, paying out one quarter of that in dividends, and retaining the remaining 12% to support its sales and assets growth. Here’s what the next six years would look like:

Years	1	2	3	4	5	6
EPS	\$4.48	\$5.02	\$5.62	\$6.29	\$7.05	\$7.90
Dividends/share	\$1.12	\$1.25	\$1.40	\$1.57	\$1.76	\$1.97

Note: Cumulative dividends equal \$9.07.

If the stock’s P/E ratio remained at 25x, the stock price would rise as follows:

Years	1	2	3	4	5	6
Price	\$112.00	\$125.44	\$140.05	\$157.35	\$176.23	\$197.38

An investor’s total dollar return over those six years would be 1) the cumulative dividends received of \$9.07 (for simplicity we will ignore the incremental returns earned on the dividends themselves) plus 2) the change in the stock price over the period, that is, $\$197.38-\$100=\$97.38$. So the total dollar return would be $\$9.07+\$97.38=\$106.45$. The investor would make 106.45% over the six year period. That’s equivalent to a compounded return of 12.84% annually. Note how important the ending price, and hence the P/E ratio, was to the return.

What if the ending P/E ratio did not hold steady at 25x? If it rose to 30x (meaning the P/E ratio would grow at a 3.1% annual rate), the ending stock price would be \$236.86. The total percentage return would rise to 145.93% which equates to an annual compounded return of 16.18%.

On the other hand, if the P/E ratio declined to 20x (meaning the P/E ratio declined at a -3.7% annual rate) the ending stock price would be only \$157.91. The total percentage return would be 67% for a compounded annual

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Expectations (continued)

return of just 8.92%.

It can get tedious calculating different scenarios but fortunately there is a useful shortcut that enables us to focus on the three key elements of return. As an approximation we can use the following equation to calculate returns:

$$\text{Annual Return} = \text{Beginning Dividend Yield} + \% \text{Change in EPS} + \% \text{Change in P/E Ratio}$$

For example, when the ending P/E ratio is 30x the approximation is $1\% + 12\% + 3.1\% = 16.1\%$. That is reasonably close to the earlier detailed projection of 16.18%. This shortcut is a much more convenient way to develop insights into the probable average returns an investor can expect from holding a portfolio of common stocks. It eliminates the need to project out earnings and dividends since all we really need are reasonable estimates of growth rates.

Estimating the Dow's Future Returns with Some Help from Jawaharal Nehru

Let's apply the approximation to the outlook for the Dow Jones Industrial Average. The Dow's current dividend yield is 2.1%. On average, EPS growth should match the growth in the Gross Domestic Product (GDP). Over

the past 50 years the Dow's earnings have grown at an annual compounded rate of 6.0%. If "real" (inflation adjusted) GDP growth averages 3% going forward and inflation averages 2.2% (the consensus prediction of inflation out to 2010), nominal GDP growth would be 5.2%. But just to be upbeat, let's take 6% as our best estimate of future EPS growth. We now have the first two terms in the equation, 2.1% and 6%.

Currently the DJIA carries a P/E ratio of 19.5x on trailing 12 month earnings. If that ratio stayed constant until the end of the decade, the expected returns from stocks would be:

$$2.1\% + 6.0\% + 0\% = 8.1\%$$

That return would be substantially below what investors enjoyed in the 1990's; how-

ever, it would not be too far off the 9 to 10% long term average return from stocks that brokers, financial planners, and the media usually cite. But one important fact stands in the way of 8.1%, and as Jawaharlal Nehru, India's first Prime Minister, sagely observed "Facts are facts and will not disappear on account of your likes." The fact is that a P/E ratio of 19.5x is very high historically. The 50 year average is 13.4x, the 20 year average is 15.3x, and the 10 year average is 18x. A conservative, prudent forecast would have to assume that today's P/E ratio is likely to revert towards "normal".

But what is normal? The 50 year average seems too low given all the changes in the economy since World War II which have decreased the risk of owning stocks. The 10 year average includes the "bubble years" of 1997-2000 so it is probably too high. Splitting the difference between the 10 year and the 20 year P/E averages would give us 16.7x which seems justifiable albeit arbitrary.

Now, if it took six years for the current P/E ratio to revert to 16.7x, the P/E ratio would have to decline 2.6% annually. In that case the expected returns from stocks would be:

$$2.1\% + 6.0\% - 2.6\% = 5.5\%$$

That's a far cry from most investors' expectations. Facts are facts and a low dividend yield coupled with a relatively high P/E ratio create high hurdles for those expecting 9 to 10% returns. What would it take to reach, say, 9.5% returns over the remainder of this decade? An ending P/E ratio of 21.2x or 10% compounded EPS growth, or some combination of the two. (The only way the dividend yield could help is if it immediately rose to 6.1%--which would imply a stock market crash.)

"IN THE BUSINESS
WORLD THE
REARVIEW MIRROR
IS ALWAYS
CLEARER THAN THE
WINDSHIELD."
WARREN BUFFETT

Expecting an increase in the P/E ratio from historically high levels seems quite optimistic. ValueLine data shows that in the 84 years since 1920 the Dow's average annual P/E has exceeded 21x on only twelve occasions with six of those coming in the past 10 years. Sustained EPS growth of 10% for the next six years also appears quite unlikely. Implicitly that would require the U.S. economy to avoid a recession or a growth slowdown for the rest of the decade.

Our conclusion is that stock returns from a broadly diversified portfolio probably will be in the mid-single digits over the next five to six years. We hope they will be much better, but we wouldn't advise clients to plan on it.

What's to be done?

It's important to remember that the preceding analysis was for the broad market as represented by the Dow Jones Industrial Average. Some stocks and sectors will do better than average and some will do worse. A key strategy for sidestepping low returns is to eschew most forms of indexing and to focus on stocks and sectors with attractive investment characteristics. Reasonable P/E ratios, dividends, solid growth prospects, undervalued assets, and good management are among the characteristics we are looking for at Patton Albertson & Miller. In addition, other investment vehicles such as international bonds, merger arbitrage, natural resource royalty trusts and the like could play a greater role in achieving good absolute returns. Be assured we will be diligently evaluating these and other means to accomplish clients' investment objectives.

Family Limited Partnerships: Are You in Jeopardy of an IRS Attack?

Recent tax court rulings have jeopardized the use of Family Limited Partnerships (FLP's) as an estate planning tool. The following checklist, while it won't guarantee immunity from an IRS attack, will certainly reduce that risk.

- FLP's should be formed while the investor is in good health.
- The partnership should be run like a business, not like a personal checkbook.
- It should have its own taxpayer identification number and bank account.
- Tax returns should be filed on time.
- Regular partnership meetings should be held and properly documented.
- The purpose of the partnership should be well documented and that purpose should involve more than just "saving taxes."
- No personal use assets should be transferred into the partnership.
- The investor should keep enough assets outside the partnership to support his or her lifestyle without relying on partnership distributions.
- Distributions of partnership income should be in proportion to ownership.
- Assets that are transferred to the partnership should be professionally appraised using reasonable criteria and assumptions.

"THE INCOME TAX HAS MADE MORE LIARS OUT OF THE AMERICAN PEOPLE THAN GOLF HAS."

WILL ROGERS
(1879– 1935)

Patton Albertson & Miller specializes in the administration of Family Limited Partnerships and we can provide the peace of mind of knowing that your partnership is being properly administered without the undue burden of the many worrisome details. Please consult your tax attorney or CPA for specific tax advice.



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Provident Trust Company Opens!

On December 15, 2003 we opened Provident Trust Company, a representative office of the National Independent Trust Company (NITC). Through our affiliation with NITC, we are able to offer a full menu of trust and fiduciary services including estate settlement, trust administration and guardianship services. Custody of assets is provided by Northern Trust Corporation, Chicago, Illinois.

The officers of the company are people you know and trust; Jimmy Patton, President, Marc Albertson, Senior Trust Officer, Bill Miller, Chief Investment Officer and Marie Andrews, Trust Officer. We look forward to meeting your trust and fiduciary needs.



HELPING
FAMILIES
MANAGE MORE
THAN MONEY