knowledgeable thoughtful ethical experienced interactive

summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors

August 2012

"You Forgot About Dividends and Productivity, Bill"

In his August 2012 newsletter, Bill Gross, probably the most successful fixed income mutual fund manager of all time, boldly proclaimed that "the cult of equity is dying". The cult of equity, as he describes it, includes the generations of investors who passively grew their wealth by holding a collection of diversified common stocks over long periods of time.

Gross notes that over the past 100 years the total return of a basket of blue chip common stocks has exceeded inflation by 6.6% on an annualized basis. Gross seems troubled by the fact that over the same time period overall growth of the US economy as represented by Gross Domestic Product (GDP) only exceed inflation by 3.5% on an annualized basis. From these two data points, he deduces that stockholders have likely been "skimming" 3% off the top of economic growth each year for a century, which he compares to a Ponzi scheme. Gross claims that a continuation of this trend is mathematically impossible by stating the following:

> "If stocks continue to appreciate at a 3% higher rate than the economy itself, then stockholders will command not only a disproportionate share of wealth but nearly all of the money in the world!"

In truth, it is not impossible for equity market returns to persistently outpace GDP growth over time.

What first needs to be established is that the stock market has not appreciated at a 3% higher rate than GDP over the last 100 years. The total return of the stock market has outpaced GDP growth by 3%. There is a huge difference between the two. Stock market total returns consist of two parts; price appreciation and dividends, with the latter making up roughly 40% of the S&P 500 Index's returns over long periods of time. Gross completely ignores dividends in his argument and therefore assumes that total return and appreciation can be used interchangeably. They can't.

For the sake of simplicity, let's assume that the stock market starts the year at a price level of $1,000. Over the course of the year, the companies that make up the stock market earn a profit of $25 collectively in an economy where GDP is unchanged (no growth). Further, assume that each company pays out all of its earnings as dividends. If investor sentiment is unchanged, at the end of the year the stock market will still be worth $1,000 after shareholders receive their $25 in dividends. Note that a 2.5% total return has been realized by shareholders, but the value of the stock market (0% appreciation) has not grown at all in relation to the overall economy (0% GDP growth).

Breaking equity returns down into appreciation and dividend payments when comparing stock market returns to GDP growth is imperative. When it comes to dividends, in almost all cases, they are received by shareholders and are either spent on everyday goods and services, used to purchase equity in another investment, or lent out to an entity that will put the cash to work. In any of these cases, dividends are redeployed into the economy as a contribution to future GDP, not "skimmed" off the top of economic growth, as Gross wants to have his readers believe.

So should equity market total returns remain in line with GDP growth over time? They haven't, and it's unlikely that they will. The rate of GDP growth and equity total returns are not always directly related. GDP is a backward looking way of measuring the amount of money that has been "spent" in the domestic economy. Importantly, GDP is unaffected by how profitable that spending is. On the other hand, the price of any common stock is a forward looking valuation of future corporate earnings or profitability. This forward looking measure of profitability is why the equity markets started to sour in 2007 before GDP fell. It is also why the market started to recover in March of 2009, well before the US was officially out of the recession according to GDP measures. GDP does not give any weight to profitability, while publicly traded equity markets revolve around it.

It is true that a company's stock price can go up because product sales go up, and this can positively impact GDP growth. A company's stock can also go up without positively adding to GDP growth if wasteful spending is cut, technology is adopted, inventory is more tightly managed, worker productivity increases and the overall entity becomes more efficient and profitable. On the other hand, a company can be a positive source to GDP growth by spending piles of money without producing sustainable profits, causing the stock price to plummet.

It is also important to realize that GDP is comprised of economic activity from all economic players including publicly traded companies, privately traded companies, consumers and the government. The "stock market", on the other hand is primarily a measuring stick of publicly traded equity performance. For example, the success or failure of thousands of small businesses will not show up directly in the annual return of the S&P 500 Index.

Now that we know the total return of the publicly traded equity markets can mathematically remain above GDP growth over time, whether or not they actually will is another topic altogether.

Even if stock returns did closely track GDP growth over time, Bill Gross would still be sour on the asset class because he is convinced that the economy, consumers and corporate profits will be in a slow growth phase for a long time to come. While this is possible, it is not etched in stone.

What Gross does not consider, and what investors who have shunned equities because of a decade of erratic, low returns can't internalize is the degree to which increases in productivity drive economic growth, wealth creation and, yes, equity returns over time.

Along with capital formation (i.e. investment) and growth in the working age population, productivity growth is the third and perhaps most important pillar of economic progress. Productivity is simply the ability to do more with less over time. The wheel, the printing press, the steam engine, the light bulb, assembly lines, air travel, telephones, computers, the internet, email, huge leaps in healthcare, GPS and thousands of smart phone ‘apps’ are just a handful of examples of historical productivity enhancers. These inventions have resulted in smarter processes, cheaper products and a more prosperous consumer, all of which tend to drive equity returns over time. A $3,000 computer becomes a $500 iPad. A month-long journey on horseback across the country becomes a 4 hour flight. A $5,000 transcontinental business trip becomes a cost-free 30 minute Skype conversation.

Sure, we are currently living in a world that is de-leveraging and recovering from the most significant economic downturn since the Great Depression, but if history is any indication, the economic hangover will not go on forever. At a certain point, one must step back and wonder how the “cult” of equity is dying when innovation and productivity gains are almost omnipresent. In my opinion, which differs materially from that of Bill Gross, the current disdain for equities has less to do with the underlying fundamentals of the US and world economy and almost everything to do with investors’ emotions, which can change on a dime.

Christopher W. Frayne, CFA, CFP®

27777 Franklin Road • Suite 1100 • Southfield, MI 48034 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com