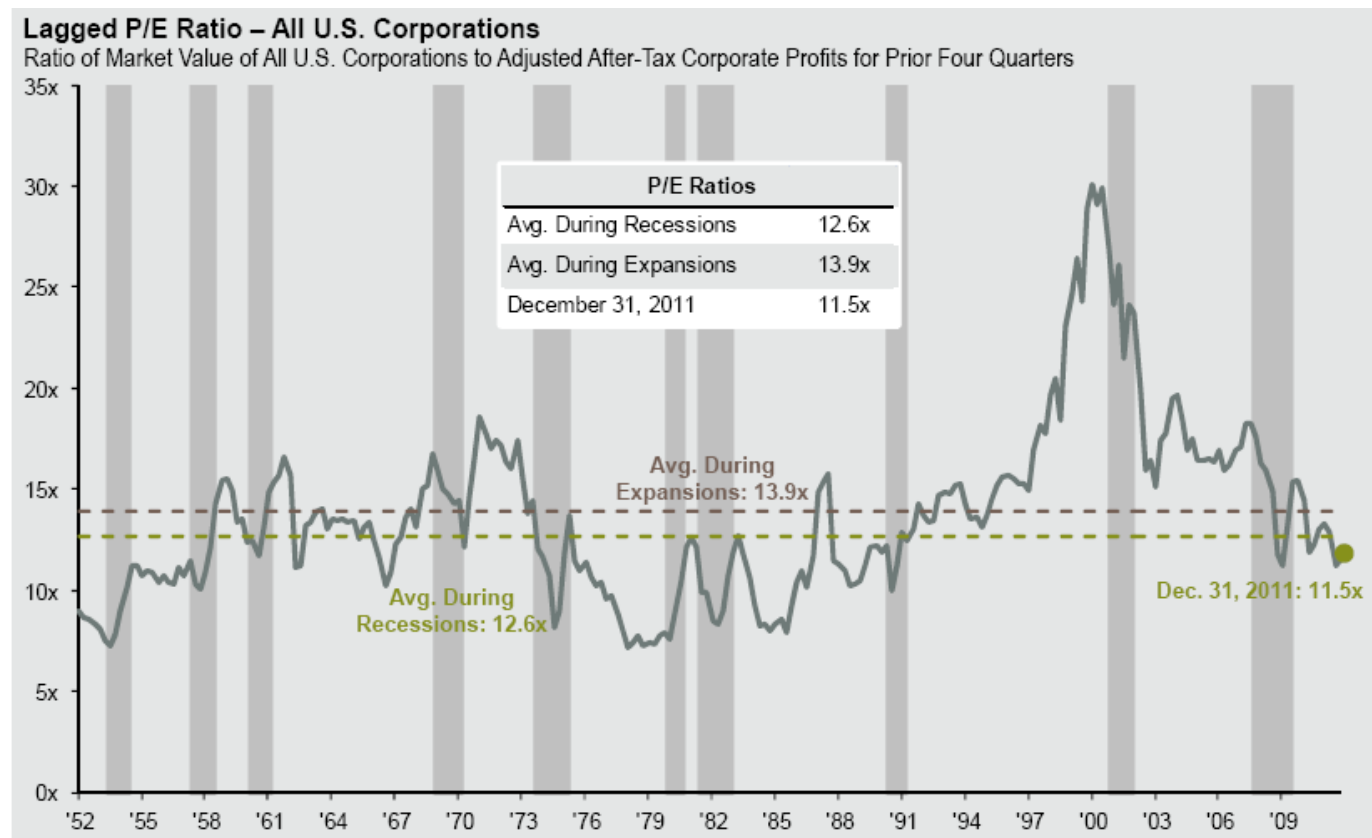


Our Ten-Year Outlook for Returns on Stocks and Bonds

At times investing in stocks can be extremely trying - and that's when times are good. In recent years market volatility has reached high levels and remained there, making the experience of investing in stocks that much more challenging. Stocks should have performed better over the last ten years in light of companies' impressive business results.

Over the last ten years the earnings of U.S. stocks, as measured by those companies in the S&P 500 Index, have doubled – averaging 7.2% growth per year. Unfortunately the performance of the S&P 500 Index hasn't kept pace, as the ten-year annual return as of Dec 31, 2011 was only 2.9%. Further, after factoring in the impact of inflation the return on stocks was almost zero. To say that this is frustrating greatly understates most investors' reaction.

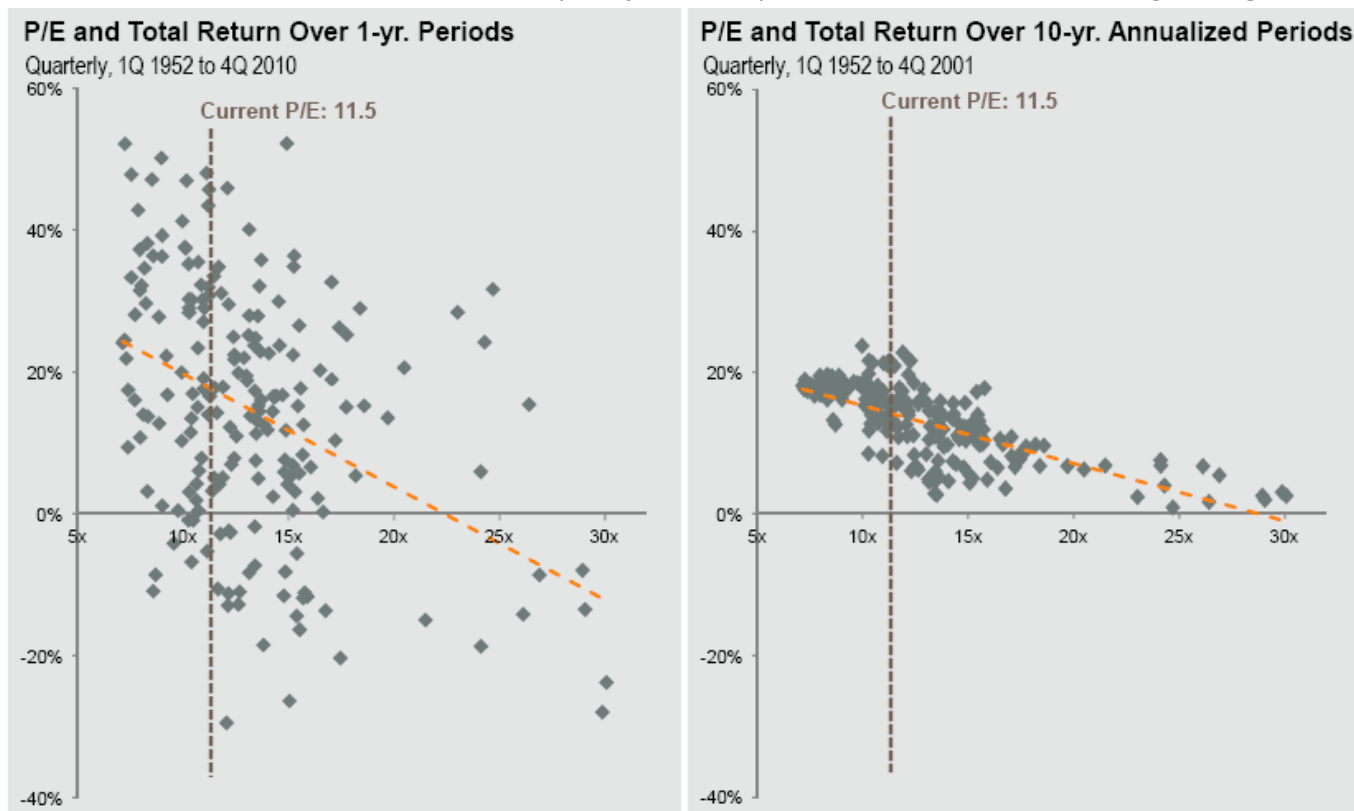


The primary culprit is investors themselves and how they price stocks. The chart above displays the price that investors have been willing to pay for each dollar of a company's earnings over time. Sometimes investors are enthusiastic about the prospects for stocks and are willing to pay more for every dollar of earnings that companies produce. At other times investors are miserly (even fearful) and require a larger margin of safety before they will buy stocks. As you can see, the price-to-earnings (P/E) ratio has fluctuated wildly from a low of about 7x in the late 1970's to a high of about 30x in 1999 and 2000. Today, investors are feeling more pessimistic than optimistic. But this is precisely when opportunities are created for higher future returns.

Important Note: Past performance is no guarantee of future results. Please do not assume that any information contained in this Insight serves as the receipt of, or as a substitute for, personalized investment advice from Madison Wealth Management.

“Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive.”
Howard Marks

The \$64,000 question is: **what will be the future returns on stocks?** The answer is: **in the short-term it’s unpredictable, but in the longer-term we can make a reasonably reliable projection.** At the end of 2011 stocks were priced at about 11.5 times earnings. As the chart on the left below shows, the future one year return on stocks when they trade at a level near 11.5 has a wide range from about -30% to +50%. This isn’t very helpful to anyone. However, when taking a longer



Source: BEA, FRB, J.P. Morgan Asset Management. Prices are based on the market value of all US corporations and include quarterly dividends. Valuation based on long-term PE ratio.

view, as displayed in the chart on the right above, the future ten year returns cluster around a much tighter range of about 10% to 20% per annum.

To further refine this, an even easier way to estimate the future returns on stocks is to calculate the current earnings yield. This is simply the inverse of the P/E ratio. Thus the earnings yield of the S&P 500 Index is about 8.7% today. Historically this has proven to be quite helpful in providing long-term estimates of stock returns after factoring in inflation. **Thus with inflation expectations at about 3% today, this means that the returns on stocks could be in the 11% to 12% range over the next ten or more years.** This would be a welcome change over the experience of the last ten years.

U.S. government bonds on the other hand don’t appear attractive at all. While they have produced returns of about 6% per year over the last ten years, they are now priced to earn not much better than 2% over the next decade. This is less than expected inflation and equivalent to a P/E of 50 times earnings! Everyone knows that driving by looking in the rearview mirror is very dangerous. Similarly, assuming that the returns on stocks and bonds for the next ten years will be like the experience of the last ten years is an equally dangerous assumption. **In fact, our view is that stocks are priced to pleasantly surprise investors over the next ten years, while U.S. government bonds are priced to extremely disappoint investors.**