THE COMPASS CHRONICLE

Highlighting important financial planning and investment issues *Vol. 2, No. 1, Spring 2003*

COMPASS Investment Advisors, LLC
Louis E. Conrad II, CFA
President
41 Forrester Street
Salem, MA 01970
Telephone: 978.828.5681
E-mail: info@compassinvest.com
Web Site: www.compassinvest.com

Our financial advisory services include:
- Investment Management
- Retirement Planning
- Education Funding
- Family Budgeting

In This Issue . . .

The Light at the End of the Tunnel

Where We Have Been

The past few years have been generally ugly for stock market investors. The three-year period ended March 31, 2003 was the worst recorded since the Great Depression era. Calendar year 2002 alone was the worst year for the S&P 500 since 1974. At the market bottom in early October of last year, the S&P 500 had fallen roughly 47% from its March 2000 peak. The NASDAQ Composite, comprised of primarily large-cap technology-related stocks, had declined more than 80% from its peak. For historical perspective, the average bear market lasts 18 months and is accompanied by a stock market decline of 37%.

Bonds, on the contrary, have basked in the dramatic decline in interest rates to 40-year lows. For the trailing three years ended March 31, bonds had generated nearly a 10% annualized return. As investors sought refuge from the falling stock market, the bond market experienced a rush of cash, pushing up prices, especially for the highest quality bonds.

Where We Are Going

So where are the capital markets headed? Now that the military campaign in Iraq is behind us, some of the uncertainty plaguing the investment environment has been removed. That said, the capital markets continue to be susceptible to event risks or economic shocks, such as nuclear proliferation in North Korea, instability in the Middle East, terrorism, SARS, corporate scandals, etc. An evaluation of the risks and rewards of stocks versus bonds appears to favor stocks presently.

The key is to not let the dismal recent performance of stocks steer you away from allocating a meaningful portion of your portfolio to stocks. While the S&P 500's dividend yield of 1.7% is low from an historical perspective, it has risen dramatically from the 1.1% level it reached at the stock market's peak (mainly due to the market's subsequent fall). Yet, its current yield is greater than the yield on Treasury bills for the first time in more than 40 years, indicating the relative attractiveness of stocks. Stocks are currently selling at 18 times estimated earnings for the next year (also known as the price/earnings or P/E ratio) versus the long-term average of about 14–15 times. However, given the historically low level of inflation and interest rates, a P/E in the low 20's could be expected. The market's heightened sensitivity to event risks and the weak economic environment will

continued on page 2

The Light at the End of the Tunnel

continued from page 1

limit investors' willingness to pay much more than 18 times for a dollar of earnings in the near term.

How much investors are willing to pay for a dollar of earnings is an important factor in the returns you can expect to achieve from stocks. The return generated from stocks can be broken down into three components: dividend income, earnings growth, and valuation (P/E) changes. According to the Bogle Financial Markets Research Center, 40% of the return generated by stocks in the 1990s was a result of investors willing to pay a greater price for a dollar of earnings than at the beginning of the decade (an increase in the P/E). Some of this was due to the speculative frenzy behind the purchase of technology and telecommunication stocks. Only 10.6% of the 17.8% annual return during the 1990s was a result of dividends and earnings. For the entire twentieth century, dividends and earnings were responsible for an average annual return of 9.6%. We shouldn't expect much more from stocks anytime soon.

So how might the decade of 2000–2009 turn out for stocks? We first need to take into account that the S&P 500 Index has lost a cumulative 37.6% for the first three years (2000–2002). *Just to break even for the decade, stocks will need to post a 7.0% annualized return for the next seven years.* Importantly, during the past 75 years, there has been just one 10-year calendar period (1929–1938) in which the S&P 500 Index generated a negative return. *To achieve a 10% annual return for the decade, in line with the historical average, the S&P 500 will need to post a 22.6% annualized return for the next seven years.* Remember, prior to the 1995–1999 period, the S&P 500 had never seen more than three consecutive calendar years with gains above 20%.

As another point of historical reference, there have been only three other time frames when the S&P 500 Index has declined in at least two consecutive years. The other periods were 1929–1932 (the Great Depression), 1939–1941 (the beginning of World War II), and 1973–1974 (the Oil Crisis). The one-year return from each respective market bottom was 137.6%, 64.3%, and 44.4%. Obviously, each period had its own set of circumstances, but the message is clear: the market can rebound rather exuberantly once conditions and perceptions change.

The outlook for bonds is perhaps not as rosy generally (see *Bonds at Risk?* in our last newsletter). As we stated there, "Given that interest rates are at 40-year lows, the likelihood has increased that interest rates are more likely to move significantly up from current levels rather than continue their decline. Consequently, bonds prices are at risk of falling and, depending on how much interest rates were to increase, could lead to a negative return…" The yield on the 10-year Treasury is only 3.7%, and with a likely increase in interest rates in the next year or two, the return potential for such a bond may not even keep pace with inflation.

As economic conditions improve, corporate bonds are likely to generate the best returns within the fixed income sector. Investors will have greater confidence that companies will be able to meet their coupon payments and principal payments at maturity. High yield bonds, commonly referred to as "junk bonds," are likely to lead the bond performance derby over the next few years. They have already shown signs of strength during the past two quarters, gaining 6.7% in the fourth quarter of 2002 and 7.6% in the first quarter of this year.

Summary

While we believe that stocks are on the road to recovery, and that lower quality corporate bonds will lead the bond market, it is important to remember to maintain a well-diversified portfolio that includes a broad mix of stocks and bonds. Don't let the latest performance of a particular asset class alter your strategic asset allocation decision.

Tired of Telemarketers?

If you are a residential telephone customer in Massachusetts, you may be interested in the following Web address (note that it begins with https) to register in the state's Do Not Call Program: https://www.madonotcall.govconnect.com/Welcome.asp

This state-sponsored program is designed to reduce the number of telemarketing calls you receive. The program became effective on April 1 and the Do Not Call list will be updated regularly. If your phone number is on the list, telemarketers and list brokers must remove your phone number from their calling lists or face a fine of up to $5,000 for each violation.

"The hangover is the worst where the party was the wildest."

Shelby M.C. Davis