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The Five Year Plan

In our last market letter, we pointed out that $1 million invested in the S&P 500 in 1968 would have become $75 million by 2013. Over the same period of time, investing that same $1 million using a P/E discipline would have grown to a staggering $573 million. This would seem to make a strong case for both long-term investing and the use of a price discipline in stock selection. But Wall Street has become increasingly consumed with short-term trading and long-term investing is generally ignored.

The problem investors have with the study is that they struggle to get their arms around such a long period of time. **One way to address the challenge is to take Ben Graham's advice and invest on a five-year basis.** Research has shown that this is a sufficient length of time to smooth out market results, with stock prices driven more by earnings and fundamentals rather than by external factors.

To demonstrate the advantages of using a five-year investment horizon, we have broken out, just below, the results for each of the consecutive five-year periods in the 45-year study (see the end of this letter for a list of the rolling five-year periods since 1968). **The results become even more remarkable when investors realize that in almost every five-year period they had to deal with a major bear market, recession or both.** What is evident here is the power of earnings growth and dividend increases over the long term. Investors might also conclude that waiting for a "good" time to invest may mean never investing at all.

5-Year Performance: 1968 – 2013
Annualized Returns

	Bottom 20% Stocks by P/E	S&P 500	Recessions	Bear Markets
1968 – 1972	9.7%	4.1%	1969 – 1970	12/1968 – 05/1970: - 36%
1973 – 1977	17.0%	-0.2%	1974 – 1975	1/1973 – 2/1974: - 46%
1978 – 1982	22.2%	14.1%	1979 1981 – 1982	4/1981 – 8/1982: - 24%
1983 – 1987	18.9%	16.5%		8/1987 – 10/1987: - 33%
1988 – 1992	15.4%	15.8%	1990 - 1991	7/1990 – 10/1990: - 20%
1993 – 1997	22.0%	20.2%		
1998 – 2002	4.7%	-0.6%	2000 - 2001	7/1998 – 8/1998: - 19% 1/2000 – 9/2001: - 34% 3/2002 – 10/2002: - 34%
2003 – 2007	17.3%	12.8%		10/2007 – 3/2009: - 56%
2008 - 2012	2.0%	1.7%	2008 - 2010	4/2011 – 10/2011: - 19%

The Study as it Relates to Today's Market

We are currently experiencing one of the most extreme melt-up markets – a bull market without a 10% correction – in the last 70 years. Such markets are always challenging for value investors. **However, looking at our study, we see that the best performance for value came after two other periods that featured a major melt-up market: the "Nifty-Fifty" bubble of the 1970's and the "Tech Bubble" of the late 1990's.**

- The Nifty-Fifty bubble was a period in market history when most investment money was going into a few, popular large cap stocks. But when the bubble burst, what followed was a great five-year period for value stocks: 1973 – 1977, +17.0% annualized vs. -0.2% for the S&P 500.

- In the study, the only five-year period without a recession or bear market was the extraordinary Tech melt-up period from 1993 – 1997. While value held its own during that five year span, the next two years of the melt-up – 1998 and 1999 – were a terrible relative period for value. However, the returns in the post-melt-up period were some of the best ever for value stocks.

	Value**	S&P 500
2000	+18.3%	-9.2%
2001	+15.5%	-11.9%
2002	-8.6%	-22.1%
2003	+37.5%	+28.6%
2004	+22.5%	+10.9%

****Bottom 20% of Stocks by P/E**

Source: SCCM Research 2014

Dealing with Difficult Five-Year Periods

Even the long-term investor with a five-year time horizon can run up against periods in which markets are flat, or down. **However, earnings tend to double roughly every ten years; accordingly, if there is a five-year period where value stocks are flat, chances are good that they will catch up to earnings in the next five years.** The table below takes all of the difficult, rolling five-year periods and highlights the annualized results in the five years that followed. The evidence clearly shows that some of the best five-year periods for value investing came after the challenging five-year period preceding them.

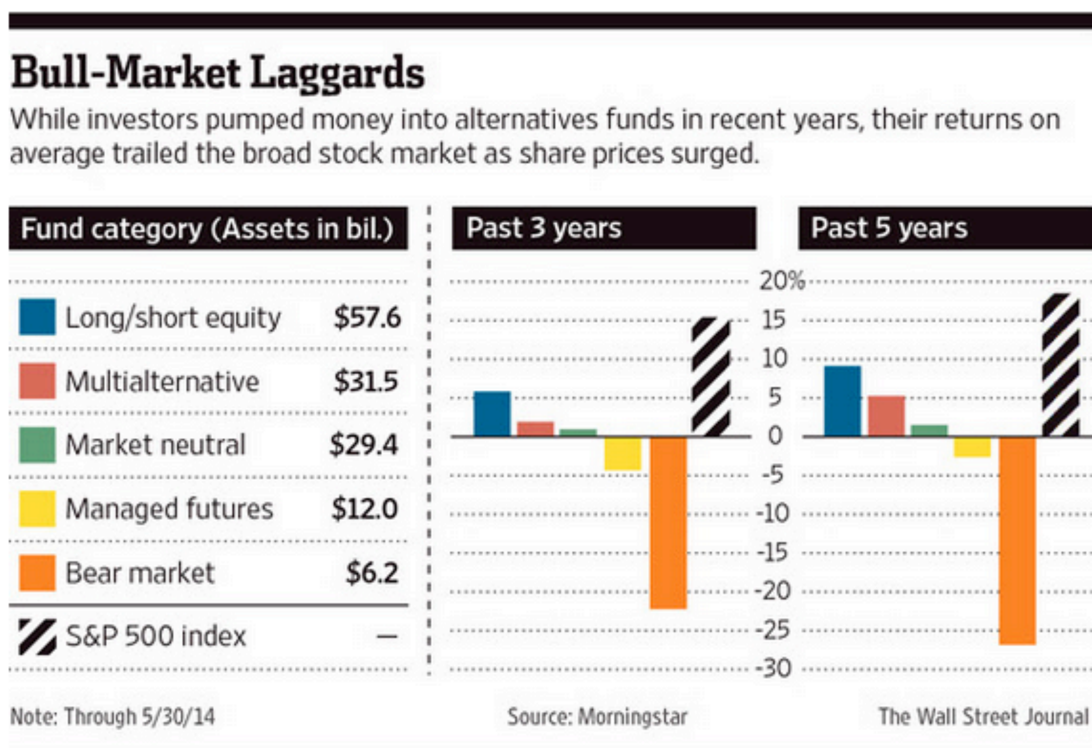
Poor 5-Year Periods	Bottom 20% Stocks by P/E	Next 5 Years	Bottom 20% Stocks by P/E
1969 – 1973	0.0%	1974 – 1978	24.7%
1970 – 1974	1.1%	1975 – 1979	34.3%
1986 – 1990	6.1%	1991 – 1995	23.2%
1998 – 2002	4.7%	2003 – 2007	17.3%
2004 – 2008	-2.3%	2009 – 2013	24.5%

Source: SCCM Research 2013

“Alternatives”: The New Hot Area of the Market

Because the severe market drops of 2000 and 2008 are still so fresh in our minds, investor confidence has been weaker than normal during the current recovery. **As a result, investors have become obsessed with downside protection and huge flows of money have been going back into bonds despite the lowest yields in history. Even larger flows have gone into a new category: “alternatives.”** What they all have in common is that they are an alternative to equities. Many are found in hedge fund strategies that are being packaged for the individual investor.

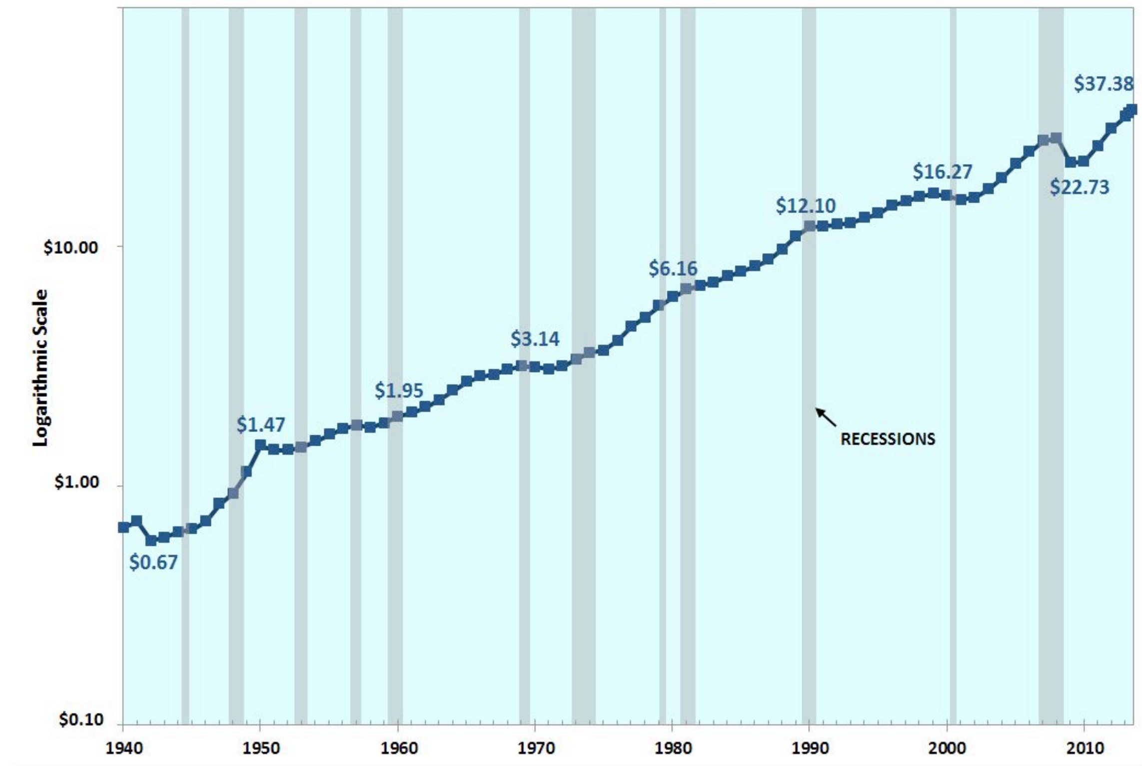
While some of the alternative investments may make sense in a diversified portfolio, the rush to buy them solely because they are supposedly not correlated to equities flies in the face of our study’s results. In addition, the chart below shows that these alternatives have not been good investments.



Dividends for Extra Downside Protection

Market history of the last 70 years shows that earnings and dividends tend to grow despite recessions, and that both tend to double approximately every ten years, thus driving the market over time. **While earnings tend to be more volatile, dividends have been very consistent. In fact, it is remarkable that dividend growth has been so consistent given 12 recessions.**

The only exception to the dividend growth story occurred during the 2008 recession when financial companies were forced by the government to cut their dividends. Meanwhile, as you can see in the updated chart below, dividends paid on the S&P 500 have since recovered to all-time highs.



Source: Ned Davis/SCCM Research 2014

Conclusion

For the long-term investor, having a healthy allocation to equities would seem to make sense as long as one invests with a value discipline and with a five-year time horizon. Also, having a dividend discipline gives investors some extra downside protection.

Determining when melt-up markets peak is nearly impossible. However, we have had 743 days without a 10% correction, which would indicate that we are reaching a point where caution is advised and investing with a discipline should start to become more rewarding.

Jim Cullen

Period	Value Bottom 20% by P/E	S&P 500	Period	Value Bottom 20% by P/E	S&P 500
1968-1972	**9.7%**	7.5%	1989-1993	**14.5%**	14.5%
1969-1973	**0.0%**	2.0%	1990-1994	**10.1%**	8.7%
1970-1974	**1.1%**	-2.4%	1991-1995	**23.2%**	16.6%
1971-1975	**12.4%**	3.2%	1992-1996	**17.9%**	15.2%
1972-1976	**17.8%**	4.9%	1993-1997	**22.0%**	20.2%
1973-1977	**17.0%**	-0.2%	1994-1998	**17.8%**	24.0%
1974-1978	**24.7%**	4.4%	1995-1999	**18.2%**	28.5%
1975-1979	**34.3%**	14.8%	1996-2000	**13.9%**	18.3%
1976-1980	**24.7%**	14.0%	1997-2001	**13.3%**	10.7%
1977-1981	**18.2%**	8.1%	1998-2002	**4.7%**	-0.6%
1978-1982	**22.2%**	14.1%	1999-2003	**12.1%**	-0.6%
1979-1983	**24.5%**	17.3%	2000-2004	**16.0%**	-2.3%
1980-1984	**26.1%**	14.8%	2001-2005	**15.4%**	0.5%
1981-1985	**26.5%**	14.7%	2002-2006	**16.0%**	6.2%
1982-1986	**27.6%**	19.9%	2003-2007	**17.3%**	12.8%
1983-1987	**18.9%**	16.5%	2004-2008	**-2.3%**	-2.2%
1984-1988	**18.2%**	15.3%	2005-2009	**2.0%**	0.4%
1985-1989	**16.3%**	20.4%	2006-2010	**2.1%**	2.3%
1986-1990	**6.1%**	13.2%	2007-2011	**-1.5%**	-0.2%
1987-1991	**10.5%**	15.3%	2008-2012	**2.0%**	1.7%
1988-1992	**15.4%**	15.8%	2009-2013	**24.7%**	17.9%

Source: SCCM Research 2014

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