ARE INVESTORS BETTER OFF?

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Ronald Reagan, in his first run against Jimmy Carter, is well remembered for asking voters whether they were better off than four years earlier. Given that the Dow Industrials broke into record territory, investors might also ask whether they are better off than nearly five and a half years ago, when the Dow last hit an all-time high. Unfortunately, the answer is no —not by a long shot. For one, the effect of inflation has eroded the value of the dollar. On an inflation-corrected basis, the Dow would have to hit 15,640 to be worth more than it was in October of 2007. In fact, October 2007 was not even the Dow's highest point in constant dollars. At the peak of the bull market in January of 2000, the Dow was just over 16,000 in today's dollars, more than 11% higher than today. For the much broader S&P 500 Index, its inflation-corrected peak of March 2000 was 2,060, more than 30% above today's levels. But investors have fallen even further behind than these numbers imply. Because of the Federal Reserve's policy of maintaining interest rates near zero, a dollar's worth of savings does not go nearly as far as it did before the financial crisis. For example, in early 2000, when the U.S. stock market was at its peak, an investor with a $500,000 nest egg in stocks could cash out and invest the proceeds in 30-year Treasury Inflation-Protected Securities (TIPS) yielding more than 4% and generate an inflation-protected income stream of about $21,000 per year. Unfortunately, at today's near-zero rates, that same investor could obtain only $2,600 of annual inflation-protected income from his $500,000 nest egg, more than 87% less than in 2000. This means that once inflation and lower interest rates are factored in, the stock market would have to rise to many multiples of its current level for an investor to enjoy the same after-inflation income today as he did 12 years ago. Although this is most discouraging for those planning to cash out their stocks and live off their savings, we believe the prospects are much better today than in 2000 for those willing to hold on to their stocks. Twelve years ago equities were selling at approximately 30 times their estimated earnings and their dividend yield was a measly 1%. But today stocks are selling at only 13.7 times their 2013 projected earnings, while their dividend yield is over 2%. Furthermore, cash dividends, which were at a record high in 2012, are rising at their fastest rate in decades. And in contrast to TIPS, whose income payments only keep up with inflation, dividends have grown 1% to 2% faster than inflation over the past half century. No one will argue with the assessment that the last decade has been horrible for stock investors. But despite the ravages of the worst bear market since the Great Depression and the worst recession in 75 years, dividend growth on the S&P 500 averaged 7% a year. And this dividend growth occurred despite the 20% collapse in dividends during the financial crisis Although there is always a risk of losing money in stocks over the short-term, history shows that there has never been a twenty year period in US stock market history when stocks investor returns have fallen behind inflation. Bonds have experienced 20-year periods where they fell behind inflation, and we would not be surprised to see them fall short again, given today's high bond prices. The financial markets have come full circle. In 2000 the stock market soared to unjustified valuations, and stock investors paid the price, with the poorest decade since the 1930s. Today bonds are stretched to their limit while we believe stocks are priced to offer investors better returns. The better question for investors is not whether they are better off now than they were when stocks were last at an all-time high, but how they can be better off going forward. With interest rates at record lows and stocks offering the best income prospects in decades, we have little doubt which asset class will win the next race. **Unless otherwise stated, data source is WisdomTree and Bloomberg.**

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