



By William W. Priest, CEO

Back to the Future

For some readers, the title of this paper may recall one of the most popular movies of 1985. In “Back to the Future,” Marty McFly, the film’s young hero, returns to the past in order to gain insight into the future. At Epoch, we believe the same approach should be taken in the field of equity investing: in order to profit from the stock market’s future, you need to understand its past. In the following pages, we’ll explore how the history of equity returns can be used to optimize stock selection, portfolio construction and total value creation.

We’ll begin our journey “back to the future” with Figures 1 and 2. These images provide a valuable interpretation of the past seven decades of stock market performance by disaggregating the three drivers of total return into their individual categories: dividends (green), earnings (blue) and P/E ratios (purple). The “combined effects” value is shown in red, and the black trend-line represents the total return for each period under review. In Figure 1, the data is displayed yearly; in Figure 2, it is displayed decade-by-decade.

Figure 1

Components of Compound Annual Total Returns for Trailing 10-year Periods
S&P 500 Composite 1926 - 2004

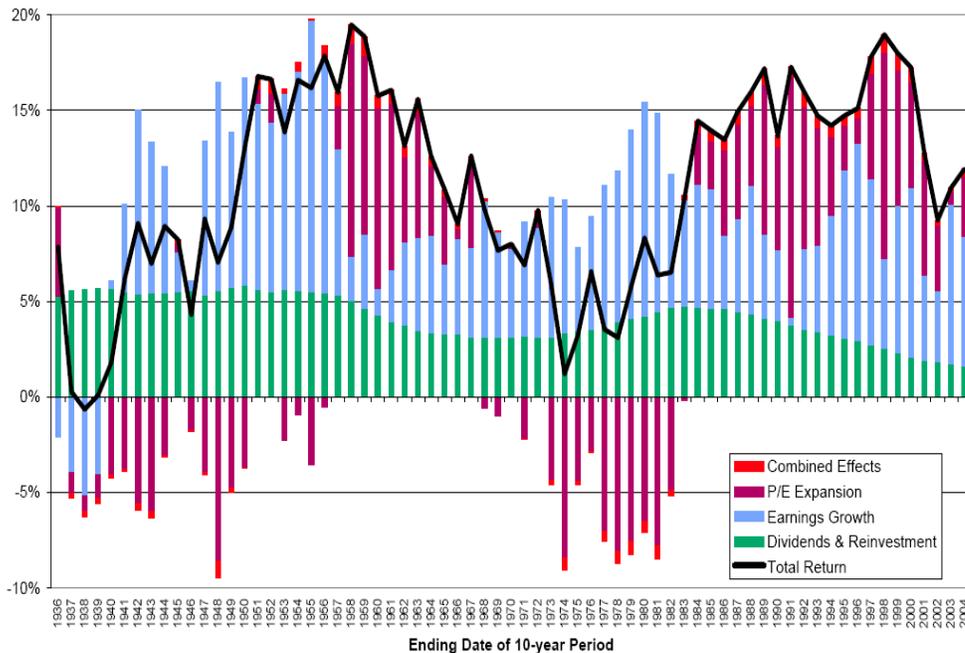
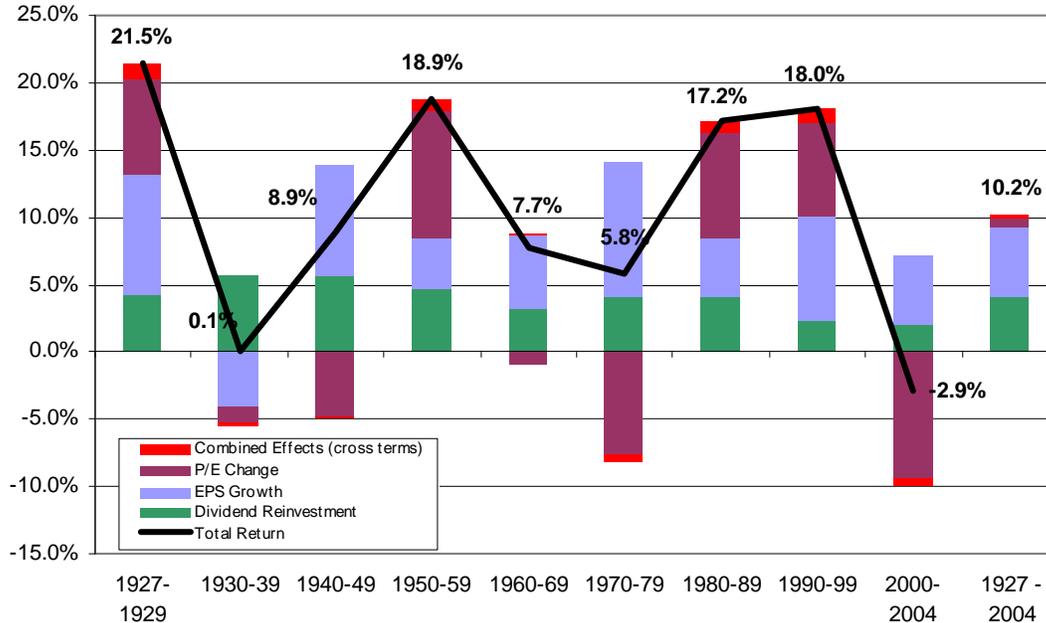


Figure 2

Components of Total Return by Decade
S&P 500 Index, 1927 - 2004



In contemplating these graphs, the informed investor – i.e. the financial equivalent of Marty McFly – will notice an important trend: in decades that generated returns above 10 percent, this growth was driven by expanding P/E ratios. The 1950’s, 1980’s and 1990’s, for example, produced large equity returns reflecting substantial P/E expansion. In fact, rising P/E ratios explained nearly half of the equity returns for the 20-year period between 1980 and 2000 (see Table 1).

Earnings Growth	6.4%
Yield	3.6%
<u>P/E Expansion</u>	<u>7.6%</u>
Annualized Return	17.6%

Conversely, in decades that produced returns below 10 percent – such as the 1940’s, 1960’s, 1970’s and the period since 2000 – this decline was explained by falling P/E ratios.

Now that we have outlined the historical role played by P/E ratios, let’s see how this knowledge can help us determine the future components of total market return. First, it is

important to remember that P/E ratios are closely and inversely tied to interest rate levels. During the decades in which P/E expansion drove returns, interest rates were in decline. Today, however, it is highly unlikely that interest rates will continue to fall, or that P/E ratios will continue to expand. Therefore, the informed investor must look beyond P/E ratios to identify the future determinants of total market return.

In our view, the key explanatory variables for upcoming positive market performance will be earnings growth and dividend yield. Particularly in light of current interest rate levels in a historical context¹, earnings and dividends will likely explain 100% of the returns this decade. In other words, valuation expansion from growing P/E ratios will no longer provide the return-driving momentum seen in prior decades. To identify the most profitable investment opportunities, one must focus instead on earnings growth and dividend yield.

This dividends- and earnings-dependent future holds an additional implication for investors: in upcoming years, P/E expansion will not cover up poorly-informed investment choices. Because tomorrow's marketplace will not be artificially buoyed by falling interest rates and rampant P/E growth, informed portfolio management will be the key to navigating this decade's new investment landscape.

In fact, when learning from the market's past in order to capitalize on its future, the topic of portfolio management should immediately come to the fore. At Epoch, we believe that successful portfolio management revolves around two separate yet interdependent issues – security selection and portfolio construction. The former deals with expected gains, and the latter attempts to minimize the risks and uncertainties surrounding the expected return of the portfolio. Security selection, therefore, is more art than science whereas portfolio construction is the reverse.

At Epoch, our security selection process is based on the generation and deployment of free cash flow. In other words, we gauge the investment worthiness of a stock in two ways: first, by evaluating a company's potential for free cash flow creation and, second, by its ability to use that cash in ways that maximize shareholder value. There are only five uses for free cash flow:

- 1) Cash dividends
- 2) Share buyback
- 3) Debt repayment
- 4) Acquisitions
- 5) Internal reinvestment

As investors, we seek to identify which of these free cash flow deployment options (or combination of options) will provide the best outcome for shareholders. If the company's management team is similarly focused on using free cash flow to generate shareholder

¹ See website (www.eipny.com) for a commentary entitled "3-11, A Rate Not a Date".

return, we will consider that stock for inclusion into our portfolios. That, in brief, is Epoch's security selection process.

After identifying stocks that meet our investment criteria, we then combine the chosen equities into a portfolio that captures the collective expected positive outcomes with a minimum of variance or volatility. We call this process portfolio construction: the second step in successful portfolio management. To understand the importance of the "science" of portfolio construction, one must simply acknowledge the existence of risks and uncertainties within the investment landscape. If a portfolio could grow from point A to point B in a straight line (i.e. without any risk at all), portfolio construction would be unnecessary, as no construction technique could improve upon the naturally occurring outcome. However, if we acknowledge the reality of risks and uncertainties within return expectations, then one must use portfolio construction to minimize those risks and uncertainties.

The key to effective portfolio construction is the ability to identify, manage and profit from four major themes. The first theme relates to the changing relative influence of each driver of equity returns. As previously mentioned, P/E ratio expansion, so important in the 1980 to 2000 period, will cease to be meaningful in this decade. Earnings (or, better yet, free cash flow) and dividends will dominate returns for this period. In our view, today's successful investment strategies must be derived from a focus on free cash flow and a commitment to free cash flow's intelligent use for the creation of shareholder value.

The second theme is the return of "shareholder yield" and its growing importance to successful security selection. Over much of the history of equity returns, dividends and their growth have accounted for almost 40% of the total return in equities. We define shareholder yield as cash dividends plus the effect of stock buybacks and debt reductions. We believe that "shareholder yield," which contributes about 3% today, will rise to 4% over the near future, and will soon comprise a large proportion of total equity market return.

The third theme is globalization, which began with the fall of the Berlin Wall in 1989 and then accelerated in earnest when China joined the World Trade Organization. With the Law of Comparative Advantage² functioning at a furious pace, the investor must have a global perspective when evaluating equities. In this new international investment landscape, the growing impact of China is a particularly important investment consideration.

The fourth theme reflects our bullish stance on energy. Here, the statistics speak for themselves: consumption of oil per capita in the U.S. is 10 times that of China. Meanwhile, China is growing twice as fast and has a population four times greater than

² This law states that every nation should specialize in producing whatever goods and services it produces most efficiently, and should then trade with other nations for the additional goods and services it desires. If every nation follows this maxim, all nations are better off than if they attempted to produce 100% of their desired goods and services internally.

the U.S. Furthermore, we believe that global oil production is likely to peak in the next few years, which will further add to the attractiveness of this sector.

In the past several pages, we've examined the equity markets of yesterday, today and tomorrow, and we've used these insights to discuss the proper approach to stock selection and portfolio construction. Now, to conclude, we'd like to offer a final reference to the movie that inspired this paper. In the film's closing scene, Doc Brown – Marty McFly's eccentric guide through the perilous maze of time travel – states the following in regard to their impending journey into the future: “Roads? Where we're going we don't need roads.” While this may be true when fiddling with the space-time continuum, we must respectfully disagree with Doc when it comes to equity investing. When one's capital is at stake, nothing is more essential than a reliable roadmap. In our view, the best possible roadmap is one that is built on a comprehensive understanding of historical equity returns. Armed with this knowledge of the stock market's past, the informed investor can certainly navigate its future.