

## Buy and Hope Investing

**More About the Long Run**  
**Stocks for the REALLY Long Run**  
**If You Don't Like the Numbers, Then Change Them**  
**Buy and Hope**  
**A Few Thoughts on Taxes and Budgets**  
**Nouriel Roubini, Yahoo Tech Ticker, and Me**  
**New York, Las Vegas, and La Jolla**

**By John Mauldin**

This week Professor Jeremy Siegel (author of *Stocks for the Long Run*) had an op-ed in the *Wall Street Journal* showing that stocks are now cheap. I was on *Tech Ticker*, and Henry Blodgett challenged me about my e-letter last week, where I talked about how expensive stocks are. So which is it? We look at Professor Siegel's work – and I let you decide.

But first, and quickly, I just wanted to take a moment and remind you to sign up for the Richard Russell Tribute Dinner, all set for Saturday, April 4 at the Manchester Grand Hyatt in San Diego – if you haven't already. This is sure to be an extraordinary evening honoring a great friend and associate of mine, and yours as well. I do hope that you can join us for a night of memories, laughs, and good fun with fellow admirers and long-time readers of Richard's *Dow Theory Letter*.

A significant number of my fellow writers and publishers have committed to attend. It is going to be an investment-writer, Richard-reader, star-studded event. If you are a fellow writer, you should make plans to attend or send me a note that I can put in a tribute book we are preparing for Richard. And feel free to mention this event in your letter as well. We want to make this night a special event for Richard and his family of readers and friends. So, if you haven't, go ahead and log on to <https://www.johnmauldin.com/russell-tribute.html> and sign up today. I wouldn't want any of you to miss out on this tribute. I look forward to sharing the evening with all of you.

There are a lot of new readers to Thoughts from the Frontline, and let me welcome you. For those of you who are not already getting your copy directly, you can get it sent to your email inbox for free, simply by going to [www.frontlinethoughts.com](http://www.frontlinethoughts.com) and typing in your email address.

### **Stocks for the REALLY Long Run**

Last week we started a series on the basics of investing. (You can read the first part here: <http://www.2000wave.com/article.asp?id=mwo022009>.) Quick review: It is my contention that the initial valuation of the stock market when you invest plays an enormous part in your subsequent long-term returns. This is clearly borne out by the data. Let me reproduce one table below. This is a critical point. It clearly demonstrates that the lower the valuation of the S&P Index in terms of the price to earnings ratio (P/E), the greater your subsequent 20-year returns.

## Buy and Hope Investing

DECILE	NET TOTAL RETURNS BY DECILE RANGE		S&P500 DECILE	AVG BEGIN	AVG END
	FROM	TO	AVG	P/E	P/E
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	6.0%	5.6%	13	12
5	6.2%	7.9%	7.0%	15	15
6	8.0%	9.0%	8.6%	16	19
7	9.0%	9.6%	9.3%	15	19
8	9.7%	11.0%	10.4%	11	20
9	11.5%	11.9%	11.7%	12	22
10	12.1%	15.0%	13.4%	10	29

*Note: P/E ratio based upon Shiller methodology*

I think most people think 20 years should be considered long-term. Looking at the S&P 500 over the past 109 years, you can find many 20-year periods where returns were less than 2-3%. And if you take into account inflation, you can find many 20- and 30-year periods where returns were negative!

So, knowing where we are in terms of P/E ratios today is very important, as it gives us a small clue as to what our prospects for returns are in the next few decades.

My good friend Peter Bernstein (who at 89 is still one of the most insightful and important analysts in the world) wrote a very insightful essay in the *Financial Times* called "The Flight of the Long Run." Let me quote a few selected paragraphs:

"The cold statistics have hardly been encouraging for the traditional [buy and hold] view. On a total return basis, the Ibbotson data show that the S&P 500 has underperformed long-term Treasury bonds for the last five-year, 10-year, and 25-year periods, and by substantial amounts.

"These data are not to be taken lightly. If the long-run expected return on bonds in the future were higher than the expected return on equities, the capitalist system would grind to a halt, because the reward system would be completely out of whack with the risks involved. After all, from the end of 1949 to the end of 2000, the S&P 500 provided a total annual return of 13.1 per cent, while long Treasuries could grind out only 5.8 per cent a year.

"But does this history really tell us anything about what lies ahead? Neither the awesome historical track record of equities nor the theoretical case is a promise of a

## Buy and Hope Investing

realized equity risk premium. John Maynard Keynes, in an immortal observation about the future, expressed the matter in simple but obvious terms: “We simply do not know.”

**“Relying on the long run for investment decisions is essentially relying on trend lines. But how certain can we be that trends are destiny? Trends bend. Trends break. Today, in fact, we have no idea where any trend lines might begin or end, or even whether any trend lines still exist.** (Emphasis mine)

Gentle Reader, pay special attention to this next paragraph: “... There is an even deeper reason to reject the long run as a guide to future investment policy. The long-run results we can discern in the data of stock market history are not a random set of numbers: **each event was the result of a preceding event rather than an independent observation.** This is a statement of the highest importance. Any starting conditions we select in the historical data cannot replicate the starting conditions at any other moment because the preceding events in the two cases are never identical. There is no predestined rate of return. There is only an expected return that may not be realized.”

For those of you who invested in 1997, with expectations of 15% forever, you can sadly confirm that last sentence.

### **If You Don't Like the Numbers, Then Change Them**

Let's be clear. I like Jeremy Siegel. He is a very nice and very smart gentleman. But in his op-ed piece, I think he was talking his book, if you can pardon the pun.

I have been writing for a long time about the rather dismal forecasting ability of the analysts who predict the earnings for the S&P 500. Each month it gets uglier. But just for fun, let's review a few charts. This first chart shows analysts' estimates for 2008. The last number is with 94% of the 500 companies reporting. Earnings forecast have been knocked down by over 70% since the end of 2007. That is a monumental miss.

## Falling Earnings Estimates for the S&P 500 for 2008

S&P Analysts estimates for earnings

Date	Earnings
March 2007	\$92
December 2007	\$84
February 2008	\$71.20
June 1, 2008	\$68.93
July 25, 2008	\$72.01
September 30, 2008	\$60
October 15, 2008	\$54.82
February 20, 2009	\$26.23!!!

Now let's look at forecasts for 2009.

## And Estimates for 2009

⌘ March 20, 2008	\$81.52
⌘ April 9, 2008	\$72.60
⌘ June 25, 2008	\$70.13
⌘ August 29, 2008	\$64.66
⌘ September 10, 2008	\$58.87
⌘ October 14, 2008	\$48.52
⌘ February 1, 2009	\$42.00
⌘ February 20, 2009	\$32.41!!!!

Based on 2008 as-reported earnings, the S&P 500, which closed at 735 today, has a trailing P/E of 52. The forward P/E, based on 2009 projected earnings, is 22.7. But the trailing 12-month P/E for the end of the second quarter, based on the last half of 2008 and

## Buy and Hope Investing

projections for 2009, is a nosebleed 51.2. (The combination of actual and projected earnings is \$14.36 per share.) Mind you, that is after a rather healthy drop in the price of the index!

In his op-ed, Jeremy says that looking at the earnings for the entire index can be misleading. “What this dismal news actually reflects is the bizarre way in which the S&P (and most other index providers) calculate “aggregate” earnings and P/E ratios for their indexes. Unlike their calculations of returns, S&P adds together, dollar for dollar, the large losses of a few firms without any regard to the market weight of the firm in the S&P 500. If they instead weight each firm’s earnings by its relative market weight, identical to how they calculate returns on the S&P 500, the earnings picture becomes far brighter.”

He uses the illustration of Exxon and Jones Apparel Group, the largest and smallest, respectively, two stocks in the index. Exxon has a weighting 1,381 times that of JAG. If by some chance one made \$10 billion and the other lost \$10 billion, the effect on aggregate earnings would add up to zero. But if you counted earnings relative to size, you would get a much different picture.

There are 80 companies which had a combined (so far) loss of \$240 billion in 2008, which takes about \$27 per share of the total earnings, although these companies only account for 6.4% of the index. If you figured earnings by market capitalization, you would get earnings at \$71.10, says Jeremy. At today’s close, that makes the P/E closer to 10! And that does sound better than my analysis above. He concludes:

“No one can deny that the recent economic downturn has badly hurt corporate earnings. But let’s not fool ourselves into thinking that this is an expensive market. When computed accurately, P/E ratios show that this market is much cheaper than is currently being reported by the S&P. Those who venture into today’s stock market are indeed buying good values.”

So which is it? A P/E of 10? Or 20? Or 50?!?!? Who is fooling whom?

First, let me state unequivocally that there are stocks in the S&P 500 that are good values. If you buy them today you will be rewarded in the medium and long run. Don’t ask me which ones, because I don’t do stocks – I have enough on my plate looking at investment managers and the economy. But there are value managers who will do well from this point. The fact that they have been hammered by 50% or more in the past year is another story for another letter. (But nearly all of them made the case that “today” was a good time to buy their fund and did so every day for the last year.)

I think there are some problems with Jeremy’s methodology. Do you weight CITI, for instance, at their market cap at the beginning of the quarter, or at the end? AIG? B of A? That could make a huge difference. And what about when the financials were contributing so much to earnings just a few years ago?

## Buy and Hope Investing

Financial stocks were 22% of the index at their highs, and an even greater share of the earnings. They are now down to 10%, and Mary Ann Bartels of Bank of America thinks they will slip to 7%. Using Jeremy's methodology, one would overweight their earnings in the go-go years and then all but ignore their losses this last year as they slipped 78% (and still falling).

### Buy and Hope

Stocks that lose money fall in price. That is no mystery. And if you are an index investor, you want to know what the index is going to do, not what just some of the stocks are going to do. If the market cap of Citibank drops by 90%, it is going to affect the index. In Jeremy's system, the positive earnings of Citibank in 2006 would be weighted 10 times more than the losses in 2008. That does not help you assess overall index value going forward.

Further, if you wanted to weight earnings by capitalization and use that number for comparison, you would need 100 years of such analysis to come up with an average trend P/E. Comparing Jeremy's cap-weighted index to aggregate data is simply apples and cumquats. It could be hugely misleading.

Quick aside: AIG has now lost over 99% of its value. It is down to \$0.42, yet next week will report a loss of \$60 billion, which I admit will skew the data even more. It makes it tough to get a real sense of it all. But even if you ignore last quarter, we are still at high valuations going forward, and as we saw from the previous charts, those earnings estimates are a moving target. They are likely to fall further.

Who might want to use such a different weighting methodology? Someone who was committed to buy and hold, has seen their portfolio trashed, and wants to hold on to some hope that their stock is going to come back. Such statistics are a kind of feel-good narcotic for the buy and hope crowd.

For the last 18 months there has been a parade of analysts, mutual fund managers, brokers, and their kin, telling you that stocks are a reasonable value "today." And they trot out "data" (with lots of charts) which supports their position and then ask you to invest "now."

"The stock market turns up six months before the end of the recession. This recession is already almost the longest, so now is the time to buy." The bullish cheerleaders said that six months ago, they say it today, and they will say it in six months. One day they will be right. Care to make a bet?

Now let's reread the last paragraph I quoted from Peter's *Financial Times* article.

"... There is an even deeper reason to reject the long run as a guide to future investment policy. The long-run results we can discern in the data of stock market history are not a random set of numbers: **each event was the result of a preceding event rather**

## Buy and Hope Investing

**than an independent observation.** This is a statement of the highest importance. Any starting conditions we select in the historical data cannot replicate the starting conditions at any other moment because the preceding events in the two cases are never identical. **There is no predestined rate of return.** There is only an expected return that may not be realized.”

We are in an economic period unlike any other we have faced. I think we are likely to have a long, slow recovery after the recession ends some time (hopefully early) next year. However, to suggest that corporate earnings are going to show the same type of resilience in 2010-2012 that they have after every other recession since WWII is ignoring the macroeconomic picture surrounding the potential for earnings growth. “Any starting conditions we select in the historical data cannot replicate the starting conditions at any other moment because the preceding events in the two cases are never identical.”

We are in a synchronized global recession. Yes, we will recover, but the causes are not those of the typical business-cycle recession. We are seeing massive debt deflation, deleveraging on a scale never witnessed, a financial industry that has to be rebuilt, and a housing industry that is reeling all over the world. We created a lot of excess in a number of industries. We decimated the savings of a generation that was hoping to retire soon, and now will have to work longer and save more.

This is not a typical recession. And for any analyst, writer, or pundit to trot out past historical data to demonstrate that the stock market is going to rebound at such and such a time and at such and such a pace simply ignores the fact that the future is unlikely to look like the past for at least the next 2-3 years. We are in a brand-new world, macroeconomically speaking.

And let me also suggest that when we do get the problems worked out, and we will, the recovery that ensues may be breathtaking in its scope, as the technological changes that will be coming down the pike in the next 5-10 years are simply going to dwarf what we have seen in the past 30. Ray Kurzweil predicts that we will see twice as much change in the next 20 years as we saw all of last century. Think about the implications of that.

Just as we cannot let past performance and wishful thinking blind us to the reality that we confront today, we must not let 3-4 years of a slow Muddle Through world after this recession ends blind us to future opportunity. Projecting the current trends into the long future is nearly always a mistake. And the longer the trend goes, the more complacent (or negative) we get. But trends change. Remember that.

Just because a stock is down by 50% does not mean it cannot go down further. Think back to all the people who said Citi was a screaming buy at \$20 or ... (pick a stock!). I want to see earnings start to settle down and maybe even rise. Given the nature of what could be the negative environment for earnings in the second quarter, there could be one more leg to this bear market. Though I must admit that I am surprised we haven't seen some type of tradable rally. I thought the money coming back into the market from

## Buy and Hope Investing

hedge fund redemptions might have been a boost, but evidently it has not been. Caution is the word today.

### A Few Thoughts on Taxes and Budgets

This week saw President Obama give us a budget with a projected deficit of \$1.75 trillion dollars, and a massive tax increase on the “wealthy.” But hidden in the details was an even larger tax increase on everyone. Obama wants to create a cap-and-trade program for carbon emissions. This is expected to generate \$79 billion in 2012, \$237 billion by 2014, and grow to \$646 billion by 2019. These will be payments by energy (primarily utility) companies to the government. That will cause utilities to have to raise the prices they charge customers for energy. Such a level of taxation is eventually 4-5% of total US GDP. That is not small potatoes. And since the wealthy do not use all that much more power than the rest of us, it will affect the lower incomes disproportionately.

It will take money out of consumers’ pockets and transfer it to the government. You can call it cap-and-trade, but it is a tax. And a huge one. Anything that will take 4% of GDP away from consumer spending is not business friendly. And by driving the cost of energy up, it will drive high-energy-using businesses away from the US to developing countries where energy is cheaper. It will make it even harder for people to save money and drive up costs for the elderly and retired. But it will make the environmental lobby happy.

Further, Obama’s accounting magicians assume that the US economy is going to grow by 1.2% this year and 3.2% next year and at a blistering 4% pace after that. Since that is not likely to happen, the deficits will be far worse than projected. Since large taxpayers can see the tax increase coming, it is likely that they will shift behavior, and tax revenues will be less than projected.

Several analysts have noted that you could tax 100% of the income of the “wealthy” and still not balance this budget. While the bottom 95% may not see their taxes rise this year, you can bet they will see them rise in the future. While the US can run multi-trillion-dollar deficits for a few years, it cannot run them for long without serious consequences for interest rates and inflation. And when our entitlement program problems hit in the middle of the next decade? You can count on higher taxes.

Just as a fragile economy is ready to pick itself back up, a large series of tax increases will help slow it down and may push us back into recession.

Which brings me back to my earlier point. Buying a stock market index in today’s environment is as much a matter of hope as it is anything else. I readily admit you can make a case for individual stocks, but a large index is a reflection of the broad economy, whether in the US or Japan or Europe. The global economy is weak and likely to be so for some time. Just as Peter pointed out at the beginning of the letter, bonds have outperformed stocks for the last 25 years, and we may see that situation continue for

## Buy and Hope Investing

another few years. We are in a period where you should be seeking absolute returns and looking for real value.

The day will come when we can start to put risk capital to work in the stock market. Today, look for ways to get absolute returns. As an example, I am reading of investors who are buying homes at deep discounts and can rent them and get 20-25% returns. That is real value. There are bonds you can get at real discounts to reasonable value because of forced sales.

### Nouriel Roubini, Yahoo Tech Ticker, and Me

Last Friday we recorded a "Conversations with John Mauldin" with Nouriel Roubini. The complete audio and transcript are already in the Membership Library. We are getting very favorable reviews. Multiple readers have let us know that the first Conversation was worth their entire year's membership, and hearing Nouriel is a special experience which you will enjoy. After the release of banking data in early March, I will do a Conversation with good buddy Chris Whalen and a few real banking experts, on where the US banking system really is. I will offer it as a bonus to those who have already subscribed, as it will be more me asking questions than a real Conversation. I expect it to be very informative.

The regular price for a yearly subscription is \$199, but you can subscribe now for \$109 and still get access to the timely Conversation with Ed Easterling and Lacy Hunt. Don't wait, as I am sure my staff will only keep raising the price. To find out more, just click on the link and put in code **JM75**, which will give you the discounted price.  
<https://www.johnmauldin.com/newsletters2.html>

And for organizations that would like to purchase a discounted multiple subscription for all their brokers or partners, just drop Tiffani a note at [conversations@2000wave.com](mailto:conversations@2000wave.com) and she will get back to you.

I did a marathon recording session with Henry Blodgett and Aaron Task of *Yahoo! Tech Ticker*. They cut it up into three segments. You can view them at:

Don't 'Buy and Hope:' How to Survive Until the Next Bull Market  
<http://bit.ly/BHGIF>

Europe's Crisis: Much Bigger Than Subprime, Worse Than U.S.  
<http://bit.ly/15xoFX>

\$1.75T Deficit, Higher Taxes, "Bogus" Stimulus: But John Mauldin Sees a Silver Lining  
<http://bit.ly/nI2aD>

### New York, Las Vegas, and La Jolla

## Buy and Hope Investing

I will be in New York in mid-March. Details are firming up. Then it's Doug Casey's "Crisis & Opportunity Summit," March 20-22 in Las Vegas, where I get to be the resident bull! [Click to learn more about the Summit.](#)

I will then go to La Jolla for my own Strategic Investment Conference, April 2-4. It is sold out, but as I mentioned at the top of the letter, you can still get tickets to the Richard Russell Tribute Dinner.

It is time to hit the send button. The Dallas Mavericks are playing tonight and my tickets are calling. It will be a busy weekend with family and lots of chores, plus more time than I would like in the office trying to catch up. Have a great week.

Your ready to have a growing economy again analyst,

John Mauldin