Revenge of the Bubble

The U.S. economy has returned to full strength. Corporate profitability is at all time highs, unemployment is low, and inflation is at bay. These are the economic facts based on the year past.

Excessive debt levels, the current account deficit, the future claims of an aging population, and an attendant weak dollar are all causes for concern. Of course, U.S. economic history is littered with such concerns, whereas only a few have developed into full blown economic storms. Moreover, we have survived economic storms in the past, and we should expect to have and survive them in the future. The problems cited above *could* cause a severe recession, significant inflation, or slower growth. Even so, Western Civilization will probably survive. Bottom-line, smart investors know that they must be prepared to weather the inevitable economic storm, and our growing debt and weakening dollar are presently a gathering storm.

Once we acknowledge the sky is unlikely to fall, but is almost certain to rain upon us someday, the issue becomes what to do. The recipe for avoiding financial distress during difficult economic times is simple, but not easy. Avoid over-valued assets and stick with quality. In the world of sports, they call it playing defense. The beauty is that by playing defense we are also playing offense. Fairly valued or under-valued assets by definition earn higher returns than over-valued assets.

There is just one problem. Circa 2005, our recipe is very difficult to follow. The bull markets of 2003 and 2004 have resulted in a return of the stock market bubble. First, a little history. The stock market contained an unprecedented speculative bubble which reached its peak in early 2000. The 2000-2002 bear market took much of the air out of it. When the market reached its bottom in the fall of 2002, stock prices had returned to a normal valuation range, though still at the high end. From there, prices have increased dramatically. For example, small company stocks are now up over 90% from their bottom. Valuation and return implications for the following major categories of stocks are as follows*:

	Earnings Yield	**Price-to-Earnings Ratio**
Large Company Stocks	4.4%	23
Mid-Sized Company Stocks	3.8%	26
Small Company Stocks	3.2%	31

The earnings yield (or earnings-to-price ratio) is a theoretically correct and practical guide to long run stock returns**. For example, a 3.2% earnings yield for small company stocks, plus a 3% inflation plug, implies a *long run* return of 6.2%. Not very appealing. However, the *short run* is of greater concern. Small company stocks could decline by roughly 50%, to a price-to-earnings of 16, and still be viewed as somewhat high in price. We have no idea if or when this will happen. The point is that a price-to-earnings

8000 Maryland Avenue, Suite 700 | St. Louis, MO 63105
t 314.932.7600 | **f** 314.932.1111 | 877.849.7733 | **acr-invest.com**

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of 16 for a riskier basket of stocks than the blue chip large company stocks is still not cheap by historical standards.

Large company stocks are reasonably high. A 4.4% earnings yield, with a 3% inflation plug, implies a 7.4% long run return. Nothing to write home about, but not too bad considering the quality of the companies. Still, there is short-term downside risk. The historical average price-to-earnings ratio from 1950-2004 was 17. A decline of 26% would return us to the historical average. Of course, there's no rule that stock prices must return to their historical average valuations or lower. Only the risk.

The average price-to-earnings of Alpine-selected stocks is currently 16. This implies a satisfactory long run return of 9.3% with a 3% inflation plug. So, our recipe of avoiding over-valued assets and sticking with quality is difficult, but not impossible, to follow. (Our actual return estimate for Alpine-selected stocks is more refined, being based on company-by-company valuations rather than the more simple earnings yield. The actual estimate is a tad higher, and does not include excess profits from shares purchased below or sold above their intrinsic values in the future).

Stock returns in the coming year, as always, are anyone's guess. If the bubble grows significantly, Alpine clients won't participate. We are currently holding a sizeable cash position, and our higher quality holdings are unlikely to do well in such an environment. But we are comfortable falling behind. We know that – the bigger the bubble, the bigger the fall. Most importantly, our returns will be higher in the long run for having avoided the bubble's revenge.

Nick Tompras
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* Large, Mid-Sized, and Small Company stocks are represented by the S&P 500, S&P 400 Mid-Cap, S&P 600 Small-Cap Indexes, respectively. Earnings are adjusted for special charges, stock compensation expense, inflated reported pension income, and normalized earning power.

** A stock's return is equal to its earnings yield plus inflation, assuming it pays out all if its earnings in dividends. Most companies retain some or all of their earnings. In these cases, the stock's return will be higher if the company's return on retained earnings is higher than its earnings yield, and vice-versa. Alpine performs more refined valuations and estimated stock returns for the indexes cited in this letter, in which we employ estimated returns on retained earnings. The implied stock returns from these valuations do not differ significantly from the stock returns implied by the earnings yield, and therefore the more simple earnings yield presented in this letter remains an appropriate guide to long run stock index returns.

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