Alley Company Quarterly Letter
Plenty of Room for Improvement

January 16, 2013

On the heels of 2012 being a very solid year in the stock market, the question of the outlook for 2013 and beyond is upon us. Expectations of return and risk are important considerations for investors in making asset allocation decisions. To gain some historical perspective on how expectations impact asset prices, consider the table below where we compare the valuation of stocks and bonds in the year 2000 versus today (2013).

Stock and Bond Valuations – Comparison

	Year 2000	Today (2013)
Stock Valuation	P/E of 25	P/E of 13
Bond Valuation	Yield of 6.2%	Yield of 1.9%

Source: Standard and Poor's and Thomson Reuters. The P/E and yield data reflect the valuation levels of the S&P 500 index and the 10-year Treasury bond, respectively, and are as of March 2000 and January 2013.

In 2000, expectations were lofty and the S&P 500 traded at a price-to-earnings (P/E) multiple of 25 as compared to today where expectations are still being met with skepticism and the S&P 500 trades at only 13 times earnings. Today, due in large part to skepticism and deflation concerns, money has flowed into bonds driving the 10-year Treasury to a yield of 1.9%. In fact, over the past six years the mutual fund industry has seen net *inflows* into bond funds and *outflows* from equity funds. Based on our judgment of expectations in these two asset classes, it appears that it is still a good time to be an investor in equities.

Reasonable valuation and low expectations may be evident, but for stocks to do well, improving fundamentals characterized by growth or positive change at the margin are needed. In our last letter we highlighted the following positive "big picture" trends: the future realization of a long-term plan addressing our debt and deficit; lower energy prices driven by the game changing natural gas and oil finds in shale rock formations all across the U.S.; the inter-related reindustrialization of manufacturing in America; the continuation of the housing recovery; and the productivity growth driven by hand-held mobile devices. These are major forces that are in motion and are an important underpinning to present and future economic growth.

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In addition to these mega trends, there is room for improvement in the near and intermediate term on some key economic metrics:

- **Jobs:** While the unemployment rate has improved to 7.8% from the Great Recession peak of 10.1%, there is still ample room for improvement. The Federal Reserve has communicated that it will stay accommodative until the unemployment rate drops to the 6.5% level.
- **Housing:** After being at the epicenter of the financial crisis, the housing market has generally stabilized and is now showing signs of sustainable improvement. Housing touches many industries and thus can be an important driver of economic growth. High rents, growing new household formation, and low mortgage rates could be factors that contribute to a multi-year improvement in the housing sector.
- **Banking sector:** The banking sector in the United States has made major strides to improve their capital ratios and balance sheets which could allow for improvement in the willingness and ability to accelerate loan growth to creditworthy customers.
- **Energy Costs:** The game changing natural gas and oil finds in the U.S. have the potential to keep a lid on energy prices benefiting consumers and businesses alike.

There are numerous stock market factors that have room for improvement as well:

- **Fund Flows:** If fundamentals continue to improve and/or interest rates begin to rise, fund flows could turn positive into equities.
- **Valuation:** The S&P 500 is trading at a P/E ratio of 13 times prospective earnings versus an historical average of 15-16 times earnings, so P/E expansion is possible.
- **Payout Ratio:** The payout ratio of dividends in the S&P 500 is about 30% versus an historical average of 50% offering the potential of attractive dividend growth in equities.
- **Current Income:** Today investors can improve their portfolio yield by investing in stocks that yield more than money markets and bonds. And as companies grow dividends through payout ratio increases and earnings growth, investors receive a hedge against potential inflation.

Our observation is that there is still plenty of room for improvement on many fronts. Improvement rarely goes in a straight line, but the direction looks favorable and hence our view that it continues to be a good time to be an investor.

We look forward to our next meeting to review the investment landscape and your portfolio.