Alley Company Commentary
Early Stage Bull Market Investing

Over long periods of time common stocks have provided the best total return for investors over virtually all other asset classes. However, this theorem has been called into question as the three year bear market has ravaged investor confidence in stocks. This is a normal occurrence because investors who have lost money in stocks tend to lose sight of the long term, sell on the way down, and then deliberate about whether the bottom was actually made while stocks strongly rebound off of bear market lows. As a general rule, investors either fail to "get back into" equities or hesitate to "add" to existing equity positions in the early stages of a bull market. The paradox is that while this behavior is understandable, it is a shame because the early stage of a bull market is by far "the best" time to buy stocks.

Throughout history, economic progress is the norm, while economic contraction is the anomaly. The United States is the greatest wealth creation machine in world history *and* countries all over the globe are importing capitalism and democracy in an effort to be like US. The ongoing "information age" will greatly enhance the opportunity for global wealth creation to occur and the U.S. will continue to benefit from that trend. The recent recession and bear market was an interruption in the long term trend of economic progress. The current economic foundation is sound with low inflation and interest rates, high productivity growth, strong corporate global positioning, and a powerful military presence. This is an oversimplification, but unless one can make the case that economic progress has forever stalled, now is the time to be optimistic about investing in common stocks when expectations are relatively low.

Consider the following stock market rallies coming out of recession.

Stock Market Bottom	GDP Trough	Length of Rally (months)	Stock Price Rise [1]
Dec-57	Apr-58	19	51%
Oct-60	Feb-61	14	34%
Jun-70	Nov-70	10	43%
Sep-74	Mar-75	18	62%
Jul-82	Nov-82	11	57%
Oct-90	Mar-91	14	37%

[1] Based on month-end price of S&P 500
Source: FactSet and UBS

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Interestingly, the first 12-18 months generated huge stock market returns and many of these rallies continued on as secular bull markets. The relevant question is, **how does one avoid missing these great opportunities?**

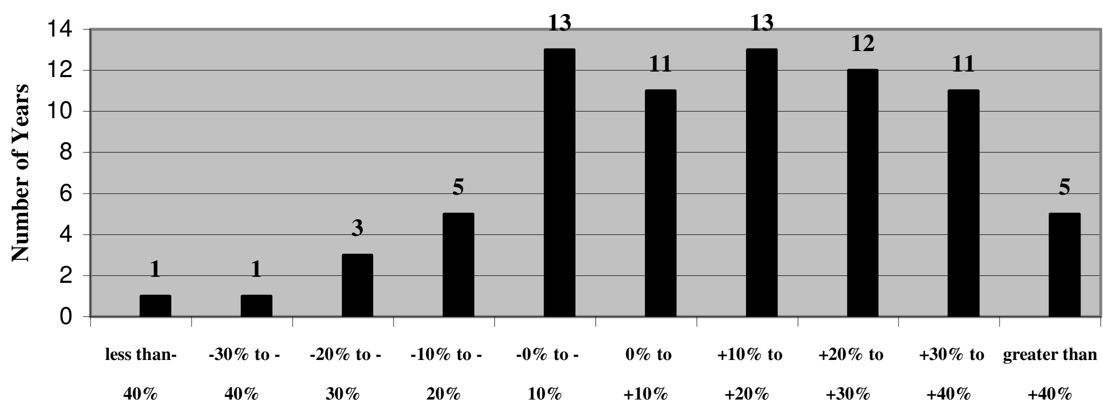
To further the discussion, consider some more facts about early stage bull market investing.

Fact: The S&P 500's worst 10-calendar-year stretch was the period ended December, 1938. During those 10 years, the S&P lost money at a rate of 0.9% a year. In the current decade, the S&P 500 has already had three consecutive losing years. If the decade that started in 2000 turns out to be just as dismal as the 10 years through 1938, stocks would have to climb 5.7% annually over the next seven years. This will easily beat 7-year treasuries which currently yield 3.7%, under this most conservative assumption of only equaling the worst 10-year period in stock market history.
Source: Wall St. Journal

Fact: A strategy of investing in stocks after 1, 2, and 3 consecutive years of negative returns has produced a higher subsequent five-year total return than the long-term compound annual growth rate of 9.6% since 1928. CAGR over the next five years is 12.0% (after 1 negative year), 14.7% (after 2 negative years), and 17.4% (after 3 negative years). There are no guarantees, but the statistical history is compelling for stocks.
Source: UBS LLC

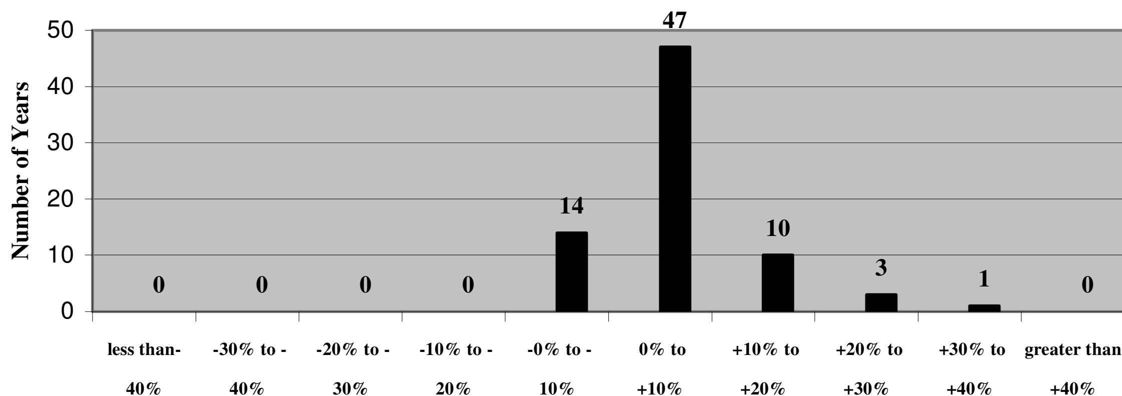
Fact: Historically, stocks post positive returns in most calendar years. The same is true for bonds, but usually in the 0-10% range.

S&P 500-Histogram of Annual Returns on Investment, Since 1928



Source: Federal Reserve, UBS LLC

T-bonds-Histogram of Annual Returns on Investment, Since 1928



Source: Federal Reserve, UBS LLC

Fact: The four-year cumulative return differential between stocks and bonds is currently at the lowest levels for stocks since the late 1920s/early 1930s, with bonds having outperformed by 54% from 1999 through 2002. The 10-year Treasury note currently stands at 4.2%, the lowest level in more than four decades.
Source: UBS LLC

Fact: Since 1956, the trailing PE for the S&P 500 has averaged 19.9x when inflation was 2-3%. This means that if the consensus S&P 500 year 2003 earnings estimate of $53.00/share materializes, by year-end 2003, the S&P 500 could trade at 1060, or 20x $53.00/share. Similarly, if the 2004 S&P 500 earnings estimate of $60.00/share becomes realistic in investors minds, the S&P 500 could trade at 1200, or 20x $60.00/share. This would provide for considerable upside in stocks from current levels.
Source: Morgan Stanley

Once again, **how does one capitalize on the favorable stock market returns that these facts suggest?**

The virtues of early stage bull marketing investing are easy to point out after the fact. Acting in a timely fashion to capture these returns is very difficult to accomplish. The only sure way to win this game is to be *fully invested in stocks* within the context of one's long term asset allocation decision. If we start with the market lows in March of 2003 as the bottom, we have been in an upswing for only six months. Interestingly, a fair amount of the bear market losses have already been erased during this short period, and those investors who remained invested captured these gains.

Capturing these *large early stage* gains has had a dramatically positive effect on the past five years performance record of the S&P 500 as well as investor portfolios. To illustrate,

Alley Company's August 31, 2003 year to date equity composite performance is up over 20%. This performance has had a huge impact on our rolling five year equity composite record which is now up approximately 4% annually through August 31, 2003, versus an annual return of about 2.5% for the S&P 500. While we are pleased to point to our favorable relative performance, what is most interesting about this is that earning 4% annually in stocks during a five year period that encompassed one of the worst bear markets in history is compelling.

If history repeats itself, it looks as though performance in stocks will continue to march up toward historical norms of 10% a year in due time. This will more than likely outstrip the annual returns in bonds relatively soon, and has already beaten annual money market rates. In just six months stocks are back in the ballgame!

There is one catch. Since most investors fail at market timing, stocks can provide superior long term results only if one remains fully invested relative to a desired allocation. For those who have more money earmarked for stocks, now is a good time because we are still early in the bull market rally, and who knows, maybe we are in for a secular run of 3-4% GDP growth, 2% ± 1% inflation, 3%+ productivity growth, and continued global dominance on many fronts. Much of this fundamental backdrop is already in place, and if it continues, the bears will be confounded and the theorem of stocks being the best asset class for the long run will once again be proven valid.

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