Alley Company Quarterly Letter
<u>The Big Three</u>

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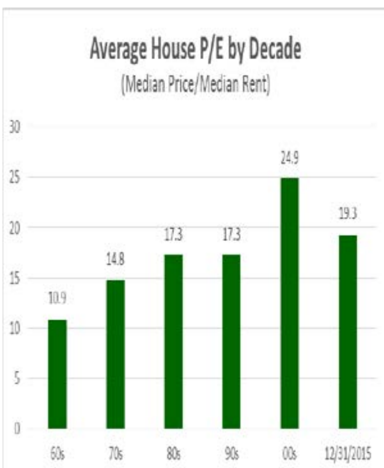
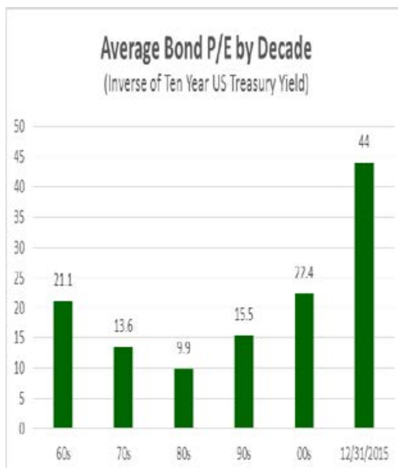
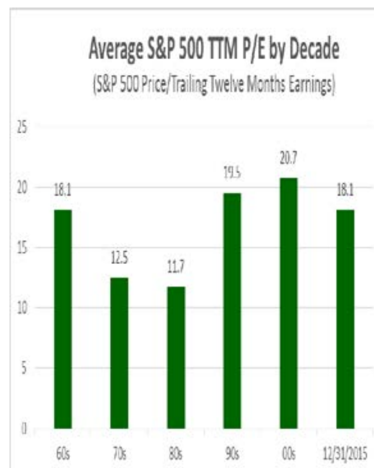
The objective of investing is to increase the purchasing power of capital. This means that the total return after taxes must exceed the inflation rate. With this all-important investment tenant in mind, an analysis of the “Big Three” asset classes - Stocks, Bonds, and Residential Real Estate - is important, as these investments, aside from one’s business interests, tend to comprise the majority of individual investor net worth. The bar charts below depict the valuation levels of these asset classes using a price-to-earnings ratio (P/E) analysis.







Sources: Vanguard Group, Census.Gov, Bureau of Labor Statistics, Morgan Stanley, and Strategas Research Group.

Analyzing P/E valuations over the past five and a half decades, a few takeaways can be highlighted:

- Residential real estate valuations peaked and then crashed in the previous decade during the housing bubble and now have migrated back toward the higher end of valuation levels.
- Bond valuations are extremely rich relative to history.
- Stock valuations are trading near average historical levels.

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Notwithstanding these takeaways, P/E analysis alone does not necessarily predict the future direction of asset class returns accurately or in a timely fashion. A great example of this is in the bond market over the past three years where the majority of pundits expected bond yields to move higher, and to their surprise they have moved significantly lower! Perhaps a more meaningful manner in which to analyze the “Big Three” asset classes is to reflect on their ability to increase purchasing power over time.

Residential Real Estate

Residential real estate has produced long-term annual nominal returns of 3-4% and when compared to annual historical inflation rates of 3-4%, the real return has been minimal[i].

- The real return is likely diluted further when considering the cost of carry (e.g., real estate taxes, maintenance expenses, insurance, etc.).
- Residential real estate as an investment requires paying expenses to maintain the investment – quite the opposite of a stock dividend or a bond coupon payment.
- The good news is that the potential loss of purchasing power in this investment can be more than offset by the satisfaction it provides home owners. Also, in some periods where real estate in certain geographic locations experiences strong price appreciation, the investment merit of residential real estate can shine.

Bonds

US government bonds have delivered long-term annual nominal returns of 5-6% and when measured against annual historical inflation rates of 3-4%, have slightly increased the purchasing power of capital.

- If interest rates continue to stay “lower for longer,” bonds will likely have a difficult time generating a positive real return.
- If interest rates were to rise, investors would face negative returns in the near term but would have the opportunity to re-invest at higher rates.
- The positive news is that bonds provide a volatility dampening effect on balanced portfolios in that they tend to be more stable than most asset classes along with generating a steady stream of income. For this reason, bonds play an important role in asset allocation.

Stocks

US stocks have produced an annual nominal total return of about 10%, which relative to historical annual inflation levels has allowed investors to achieve a meaningful positive “real” return.

- During periods of high inflation and interest rates, stocks have been penalized with low valuations (see 1970s and 1980s bar charts). Given that the current environment is exactly the opposite with low levels of inflation and interest rates, a case can be made for stock valuations to be higher than normal.

- Stocks can provide a hedge against inflation. A stock is a claim on the real assets of a company and can appreciate in value over time driven by the earnings and cash flow growth generated by these assets.
- Stocks, however, are more volatile in the short term and any proper asset allocation structure must give credence to this characteristic.

Conclusion

The Big Three play an important role in one's asset allocation structure, each for a different reason. Stocks, over long periods of time, have consistently increased purchasing power and been viewed as a hedge against inflation. Bonds at times have increased purchasing power, but largely are utilized to dampen overall portfolio volatility and generate income. And while residential real estate may not always increase one's purchasing power, the satisfaction and quality of life factors that a home offers are priceless. Blended together in the right proportions, the Big Three can serve the purpose of generating an adequate "real" return for investors that helps meet their goals and objectives.

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[i] Historical Asset Class Returns are from Morningstar with a start date of 1926 and ending at year end 2015. Historical residential real estate returns are from S&P Case-Schiller Index and cited in the article "Real Estate Investment Performance" from www.awealthofcommonsense.com.

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