Alley Company Quarterly Letter
A New Decade

January 14, 2020

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go." -- Benjamin Graham

For investors, the turn of the calendar to a new decade is just another point in time, but it nonetheless offers a convenient breakpoint to re-evaluate the "big picture," including goals, objectives, and risk tolerance, and to reaffirm commitment to a disciplined **investment philosophy**.

At its core, investing is about optimism. After all, investors essentially cede control of their capital *today* for the prospect of a favorable "return on investment" in the future. The primary objective is to beat the rate of inflation so as to maintain the purchasing power of capital. Pessimism, on the other hand, is a seductive force that can lead investors to debilitating and counterproductive behaviors, including the ill-advised but not uncommon attempt to "time the market."

As we embark on a new decade, a look back at historical investment returns is instructive and provides context for why optimism is the most reasonable stance for the long pull. The table below shows stock and bond market returns for the past nine decades.

Stocks, Bonds, and Risk by Decade

Decade	Bond Market	Stock Market	Stock Market Standard Deviation	$1.00 in Stock Market grew to:
2010s	3.8%	13.5%	11.6	$3.55
2000s	6.3%	-1.0%	20.2	$0.91
1990s	7.7%	18.3%	13.7	$5.37
1980s	12.4%	17.7%	12.2	$5.09
1970s	7.0%	5.8%	18.7	$1.76
1960s	3.5%	7.8%	14.2	$2.11
1950s	1.3%	19.6%	19.1	$5.99
1940s	1.8%	9.1%	16.1	$2.38
1930s	4.6%	-0.1%	33.1	$0.99
Averages:	**5.4%**	**10.1%**	**17.7**	**$3.13**

Notes: Stock market data is obtained from Prof. Robert Shiller and Yahoo Finance and represents the S&P 500 Index. Bond Market data is obtained from Morningstar and represents a broad Government Bond Index. All return data represents the Compound Annual Growth Rate (CAGR) for the period defined. Standard Deviation is a statistical measurement of the volatility of returns and is commonly cited as a measurement of risk (the higher the standard deviation, the higher the risk associated with the period measured). Past performance is not a guarantee of future results. The impact of inflation is not reflected in these data. Investors cannot invest directly in an index.

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

There are any number of useful insights that can be taken from the historical data in the table above, but we offer the following short list of observations with the purpose of helping investors think about the path forward over the coming decade:

- Stock market returns on average have been almost double bond market returns. This reflects the reward that equity investors typically receive for the willingness, ability, and mindset of being an *owner* in a business relative to that of being a *lender* to a business.

- While stock market returns in the 2010s were indeed above average, this would be at least somewhat expected having come off the worst decade in modern history. (The 2000s included not just one, but two bear-market periods, including the aftermath of the dot com bubble and the September 11th terrorist attacks as well as the global financial crisis itself.)

- The poorest returns for the bond market occurred in the 1940s and 1950s – this was an extended period of low interest rates in the U.S. Today's interest rate environment is showing similar signs to that two-decade period (please read our past letters Q2 2019 – Two Percent, Q3 2018 – Stocks, Bonds, and Interest Rates, and Q2 2015 – Déjà Vu?).

- Despite seemingly no shortage of risk factors in the 2010s (e.g., geopolitical tensions, divisiveness in U.S. politics, negative interest rates outside the U.S. and inverted yield curves inside the U.S., etc., etc.), the decade actually had the *lowest* risk of the past nine as measured by the standard deviation of returns. The highest risk periods (1930s and 2000s) tend to occur around major disruptions in markets.

- The 1980s and 1990s were back-to-back banner decades. While this period was fruitful for investors in that era, it left valuations in the stock market at peak levels at the end of the 1990s. The table below depicts the high valuation levels of that time and how valuations today are far less lofty, *especially* when considering the respective levels of interest rates.

Valuation Comparison – Then and Now

Metric	2000	Today
S&P 500 Index	1,527	3,283
Forward P/E Ratio	27.2x	18.2x
Dividend Yield	1.1%	1.8%
10-Year Treasury Yield	6.2%	1.8%
Percent of S&P 500 Companies w/ Div. Yield greater than 10-Yr. Treasury Yield	6%	54%

Notes: Data for '2000' is obtained from Barron's and is as of the market peak of March 24, 2000. Data for 'Today' is obtained from Thomson Reuters and JPM Guide to the Markets and is as of January 14, 2020. Forward P/E Ratio represents the index price divided by the expected next-twelve-months earnings per share.

At the dawn of this new decade, there is much to be optimistic about. Big and important trends have developed and look likely to continue with positive implications for investors: the use of various forms of technology are permeating the business world on a global basis, leading to advances in productivity; innovation in healthcare is leading to better outcomes, including a declining cancer death rate; the consumer sector of the economy, which represents two-thirds of U.S. GDP, is benefiting from low unemployment and rising real wages; the U.S. banking sector is arguably in its strongest position ever based on capital ratios and low loan losses; the U.S. has reached "energy independence" after decades of relying on others for these resources; and low interest rates are both a boon to borrowers and represent a low 'discount rate' for the valuation of equity securities.

As legendary investor and scholar Benjamin Graham stated, investors need a financial plan and behavioral discipline to get to where they want to go. With this in mind, we will continue to take a long-term perspective and remain disciplined in the face of short-term volatility. By focusing on the things we can control – an appropriate asset allocation, diversification, investing in high-quality cash generative businesses, attractive dividend income, and managing portfolio turnover and tax efficiency – we will be well positioned to make the most of what the capital markets have to offer.