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2005 in Review: All About Earnings

As 2005 opened, we believed the stock market averages had little upside. Based on Goldman Sachs' earnings estimate of $66.50, the S&P 500 was trading at 18.2 times earnings. This compared to historical averages of 18.6 times earnings when inflation has been less than 2.5% and 17.7 times when inflation has been in the 2.5% to 3.5% range. Actual inflation was 3.5% in 2004 while so-called "core inflation" – which excludes food and energy – was 2%.

Meanwhile, the Value Line Composite opened 2005 at an above-average 19.1 times earnings. According to Value Line, the median stock had estimated 3-5 year price appreciation potential of 35%. Our studies indicate Value Line tends to be optimistic with appreciation potential of 35% or less associated flattish returns over the next five years.

As it turns out, S&P earnings exceeded Goldman's estimates for the third consecutive year. Goldman's most recent estimate for 2005 is $70.50. This 6% upward revision exceeded the 4.7% return for the S&P. The Value Line Composite saw its valuation contract to 18.3 times earnings. This decline in valuation offset most of the increase in earnings.

All in all, these results confirm our belief that returns for the market averages going forward are dependent on earnings growth and dividend payments. Without help from valuation gains, returns will continue to be muted.

2006: Things are Looking Up?

The S&P 500 has been on a roller coaster to nowhere over the past seven years. Closing as high as 1527 in March 2000 and as low as 776 in October 2002, the S&P has advanced less than 2% from the end of 1998 to the end of 2005. Meanwhile, operating earnings grew from $45.79 to an estimated $70.50. As the table below indicates, this 50% increase in earnings reduced the S&P's year-end price/earnings multiple from an astronomic 26.9 to a reasonable 17.7. With reported inflation of 3.5% for the twelve months ending November 2005, this is exactly the P/E one would expect.

Date	S&P 500 Closing Price	Calendar Year Operating Earnings	P/E Multiple at Year End
12/31/1998	1229.93	45.79	26.9
12/31/1999	1469.25	50.96	28.8
12/31/2000	1320.28	52.84	25.0
12/31/2001	1148.08	33.40	34.4
12/31/2002	879.82	42.00	20.9
12/31/2003	1111.92	54.24	20.5
12/31/2004	1211.92	64.89	18.7
12/31/2005	1248.29	***70.50(E)***	***17.7***
12/31/2006	***1248.29***	***75.00(E)***	***16.6***

Calendar Year Operating Earnings and 2006 estimate provided by Goldman Sachs
Figures for 2005 and 2006 include $3 of options compensation expense

Looking at 2006, the S&P appears undervalued at 16.6 times Goldman's earnings estimate of $75. Appreciation potential is greater if inflation falls below 2.5%. However, even if inflation stays at 3.5%, the S&P should see an increase commensurate with earnings growth. Six percent earnings growth plus a 2% dividend yield would produce an 8% total return. This doesn't sound like much but it is the first time in nearly a decade that investors in the S&P will not be swimming against the tide.

The outlook for the median stock is not as bright. The Value Line Composite enters 2006 at 18.3 times earnings with median 3-5 year appreciation potential of 40%. The Value Line appears fairly valued rather than undervalued.

Upside for these benchmarks could come from higher than expected earnings, lower than expected inflation and/or valuations above historical norms. Downside risk is represented by worse than expected earnings, higher than expected inflation and/or valuations below historical norms.

Tinier Bubbles

The real estate bubble extant in much of the country is finally deflating. Here in Santa Cruz, residential real estate listings are up 60% year over year while sales are down 30%. Prices are weakening and further weakness seems inevitable. Other hot markets like San Diego and Phoenix are seeing similar trends. Some of the large homebuilders are reducing earnings expectations for 2006 and 2007.

The end of the bubble brings the beginning of crunch time for the economy. How much consumer spending has been driven by the wealth effect of higher real estate prices? How much spending has been supported by falling interest rates and cash-out refi's? Will the ripple effects of the bust be limited to those directly involved as happened when the high-tech bubble burst or will the effects be more widespread?

Frankly, we cannot answer these questions. However, we have prepared for this day by greatly reducing our exposure to the housing industry. Over the past two years, we have sold our homebuilder, our mortgage guarantors, our mortgage originator and our building supply company. Our only remaining exposure is a single home improvement retailer. We are keeping this investment as home improvement tends to accelerate when housing turnover decelerates. We have increased our exposure to health care, energy and industrial stocks.

Out of the Frying Pan

In his book "Winning on Wall Street," Martin Zweig found that bear markets do not occur unless at least one of three conditions is present. These conditions are deflation, ultrahigh price/earnings ratios or an inverted yield curve. Zweig defines a bear market as a decline of 15% or more in the S&P 500, the Dow Jones Industrials and the Value Line Composite. An ultrahigh P/E ratio is defined as 18 times earnings for the S&P or 20 times earnings for the Dow. Zweig uses the difference between 6-month commercial paper and the Moody's Aaa Corporate Bond Yield to measure the yield curve.

As noted above, P/E ratios have been ultrahigh for years but have finally moved below the danger zone. Inflation has been accelerating and deflation is nowhere in sight. However, the corporate yield curve is flattening and could become inverted. Indeed, the Treasury yield curve became partially inverted last month.

Inverted yield curves are dangerous because they often precede recessions and recessions always result in bear markets. However, not all inversions result in recessions. If and when the corporate yield curve inverts, it will be a factor that to weigh carefully.

Summary

For the first time in years, the S&P 500 can be considered undervalued by historical metrics. Although the rally in the second half of 2005 reduced some of the potential outlined in our July 2005 letter, collective risk/reward ratios for our holdings remain favorable. We believe our valuation targets are appropriately conservative in light of the uncertainties related to the housing bubble, energy prices, the war in Iraq, federal budget deficits and tax policy. We intend to remain disciplined in our buying and our selling. We will use cash when opportunities appear and hold cash when opportunities are absent.

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