

HOUSTON BUSINESS JOURNAL

Strictly Houston. Strictly Business.

Vol. 37, No. 20 Week of September 29-October 5, 2006

Adage needs to be changed for today's investment environment

Investors wonder where growth is to be found today. One thing is certain: It's not in the rearview mirror. The past 25 years presented a uniquely favorable investment environment in United States financial markets — the likes of which most may never see again.

From the bottom of the market in August 1982 to the peak in August 2000, the S&P 500 index returned 18.7 percent a year. This was 18 years of above-trend wealth creation in the stock market. The bond market had an even more successful run. The 10-year U.S. Treasury peaked at 15.8 percent on Sept. 30, 1981, and dropped to 3.1 percent on June 13, 2003. That's an almost 22-year bull market in bonds. The decline in interest rates from peak to trough is the greatest drop on record, by far. It is not much of a stretch to conclude that the bond market will probably not repeat this performance from its current level.

Dissecting the return of the S&P 500, it can be observed that the 18.7 percent annual return came from:

- Dividends — 3.6 percent (assuming index reinvestment).
- Reported earnings growth — 7.6 percent.
- Price-to-earnings ratio expansion — 7.5 percent.

Thus, even while ignoring the positive impact on consumers and businesses of declining interest rates, a significant portion of equity return resulted from multiple expansion as a result of the steep decline in interest rates.

The relative growth rates of earnings over the course of a business cycle, and longer, are a significant factor in the coincident performance of the underlying stocks of different companies.

Many companies have earnings that strong-



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ly correlate to the economic cycle. Industrials, materials, consumer cyclicals and technology companies generally fit that bill. Conversely, certain companies exhibit earnings qualities that are more bond-like. That is, they have revenue, earnings and dividend streams that are stable and dependable over long periods regardless of the overall performance of the economy. Some health care companies and telecoms have historically had those characteristics, but it is electric utilities and consumer staples that most closely resemble bonds.

Consumer staples companies like PepsiCo Inc., The Coca-Cola Co., Procter & Gamble Co., Gillette Co. and Colgate-Palmolive Co. became premier growth stocks from the 1980s through 2000. For example, Coca-Cola shares returned a 24 percent compounded annual growth rate, including a roughly 2 percent dividend yield. However Coca-Cola's earnings per share during that period grew at a 9.7 percent rate, which was less than half the rate at which its shares appreciated.

Medtronic Inc., a small, emerging medical device company, is an example of another growth stock which performed well during the period in question. Its shares returned 28.5 percent. But its EPS grew 16.7 percent during that period.

Coca-Cola shares appreciated at 80 percent of the rate of Medtronic shares although its EPS grew at only 60 percent of the rate that Medtronic's EPS did. Obviously, there was a materially greater P/E expansion for Coke than Medtronic. Coke's bond-like features rewarded investors.

Ahead is likely to be an economy that will exhibit slower long-term growth than that of the past decade or two and without the tailwind provided by a record drop in interest rates. Given that investors should not expect much help from bonds in the years ahead, it will be critical to find companies whose earnings growth rates significantly outpace those of the market in order to achieve above-average returns. The old-guard growth companies probably won't have the EPS growth it will

take to provide significant outperformance.

Innovative companies that can provide above-market robust long-term earnings growth may be found in areas such as materials, energy and particularly health care. Houston, with its world-class medical center and universities to provide leading researchers in the fields of biotechnology and materials sciences, is well situated in such an environment.

One old investment philosophy says "buy the best companies and hold them." Ford Motor Co., Eastman Kodak Co., Bristol-Myers Squibb Co. and hundreds of other underperforming stocks were once among the "best" companies. In 1986 Microsoft Corp. would not have been viewed as one of the best companies. Nor would Amgen Inc., Genentech Inc., Intel Corp., Medtronic, St. Jude Medical Inc. — the list is lengthy. And yet, a small investment in even one of these companies could have had a significant positive effect on returns.

Consider this: if an investor put \$100,000 in an S&P 500 index fund Dec. 31, 1985, and held it, he would have about \$951,000 on Dec. 31, 2005, an 11.9 percent compounded annual growth rate. Alternatively, using the same buy-and-hold strategy, if he had bought \$5,000 worth of Amgen Inc. and invested the remaining \$95,000 poorly at 5 percent, he would have about \$1,650,000 on Dec. 31, 2005, for a 15 percent return. Actually, he could have lost the entire \$95,000 and still come out with almost \$1,400,000 worth of Amgen.

Maybe a better adage should be "buy some of the most promising growth companies at reasonable prices and hold them." Not as pithy, but then, investing for above-average returns over the long-term is not simple either.

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