

Memo to: Oaktree Clients
From: Howard Marks
Re: The Outlook for Equities

It doesn't take much to get me started on a memo. In this case one sentence was enough, in an article from the February 4 online edition of *Pensions & Investments*, as described by *FierceFinance* on February 28: "The long-term equity risk premium is typically between 4.5% and 5%."

There's little I hate more than investment generalizations. For years, for example, self-styled authorities on the high yield bond market would say "bond defaults typically take place 2-3 years after issuance." That always set my teeth on edge. The time to default might average 2-3 years, but unless (1) that's also the most common time period (the mode) and (2) not a highly variable parameter (which I think it is), that generalization is absolutely useless.

In fact, I like the way Mark Twain summed up on the subject more than 100 years ago: "all generalizations are false, including this one." I consider most investment generalizations as useless as that great oxymoron: "common sense."

Back to equity risk premiums. The *FierceFinance* article in question led with the sentence, "The 'great rotation' back into equities from bonds is unlikely to be seen in 2013 among most defined benefit pension funds in major markets, including the U.S., U.K. and Netherlands." It included a number of what I consider provocative statements:

- that pension funds do want fewer bonds but generally not more stocks (raising the question of where the money will go, and specifically how much money can responsibly be absorbed in asset classes other than stocks and bonds),
- that, according to one consultant "There is recognition that bonds represent minimal-risk assets, so it's difficult for (plan executives) to abandon bonds in favor of equities. . ." (This overlooks the fact that there's no such thing as a minimal-risk asset regardless of price, and few assets that have been the beneficiaries of years of strong cash inflows can really be "minimal-risk"), and
- "that investors are taking short-term tactical advantage of the rising equity premium by, for example, allowing multiasset managers to drift toward the higher end of the equity allocation range."

So there we are, in the third bullet point, back to the matter of the equity risk premium.

Everything You Ever Wanted to Know About Equity Risk Premiums (and Much More)

The equity risk premium is generally defined as, "the excess return that an individual stock or the overall stock market provides over a risk-free rate." (Investopedia) Thus it is the incremental return that investors in equities receive relative to the risk-free rate as compensation for bearing the risk involved.

The term is also used to describe the extent to which the return on stocks exceeds the return on bonds, again as compensation for bearing incremental risk. (For example, an August 18, 2011 article on the *Seeking Alpha* website, entitled “What the Equity Risk Premium Is Saying,” discusses the prospects for stocks versus the ten-year U.S. Treasury note.)

My real problem with the term – or, more correctly, the way it’s used – has to do with one of the littlest words in the English language. Or, to paraphrase a former President of the United States, “it all depends on the meaning of the word is.”

Many people know what they think they mean when they talk about the existence and magnitude of the equity risk premium – or even what they actually mean – but I don’t think many are logical or consistent in using it. My complaints surround the definition they apply to the term, and specifically the tense of the verb they employ (I’m not just being grammatically picky).

Most specifically, I strongly dislike the use of the present tense, as exemplified by the writer for *P&I*: “The long-term equity risk premium is typically between 4.5% and 5%.” This suggests that the premium is something that solidly exists in a fixed amount and can be counted on to pay off in the future.

Imagine instead that she had said “The long-term equity risk premium has typically been between 4.5% and 5%.” This makes the premium seem more like a historical fact but also less dependable in the future (probably as it should be).

The equity risk premium can actually be defined at least four different ways, I think:

1. The historic excess of equity returns over the risk-free rate.
2. The minimum incremental return that people demanded in the past to make them shift from the risk-free asset to equities.
3. The minimum incremental return that people are demanding today to make them shift away from the risk-free asset and into equities.
4. The margin by which equity returns will exceed the risk-free rate in the future.

The four uses for the term are different and, importantly, all four are applied from time to time. And I’m sure the four uses are often confused. Clearly the import of the term is very different depending on which definition is chosen. **The one that really matters, in my opinion, is the fourth: what will be the payoff from equity investing. It’s also the one about which it’s least reasonable to use the word “is,” as if the risk premium is a fact.**

What Will Equities Give You?

There are problems with at least three of the four meanings. Only **number one** can be measured. There’s a lot of data on the historic performance of stocks versus bonds and cash. In fact, in the 1990s Wharton Professor Jeremy Siegel documented to a fare-thee-well that stocks always won out over long periods of time. Of course the subsequent decade proved that didn’t have to remain the case.

Now it gets more interesting. Although we can calculate the amount by which stocks outperformed bonds or cash in the past (assuming you were looking at periods prior to 2000), I don’t think that’s the same as saying what risk premium was demanded by investors in the sense of **definition number two** above. If stocks outperformed by 5% over a ten-year period, that doesn’t mean people demanded a 5% higher return to buy equities rather than bonds or the risk-free asset. They might have “demanded” more or less. It’s just that they got 5%.

In a similar vein, we can also talk about **number three**, the minimum return increment people are demanding today. But (a) the answer you come up with will depend on whom you ask, (b) they may or may not have given it rigorous thought, and (c) whatever they say is likely to have little impact on what relative returns turn out to be. Their answer is likely to tell you more about what they think they'll get than about what they're actually demanding . . . or what they will get.

What matters for today's investor isn't what stocks returned in the past, or what equity investors demanded in the past or think they're demanding today. What matters is **definition number four**, what relative performance will be in the future. **The most important thing of all is to realize that this can't be read anywhere.** As Einstein said, in one of my favorite quotes, "Not everything that counts can be counted, and not everything that can be counted counts."

Just as number four is the most important definition of the equity risk premium, the questions surrounding it are also significant. In my view, people tend to think of the equity risk premium (and other risk premiums) like credit spreads on bonds. I've been dealing with credit spreads for 35 years. They are the entire *raison d'être* for high yield bond investing. **And they have almost nothing in common with the equity risk premium.**

Let's say we want to assess the adequacy of the reward being offered for bearing the credit risk of a given B-rated high yield bond. We compute the yield to maturity or yield to call on the bond and subtract from it the yield to maturity on a Treasury security of the same duration. The result is the "yield spread" or "credit spread." That spread tells us what the prospective relative return is and – when assessed in the light of historic spreads, the spreads on other bonds, the riskiness of the bond in question, and the spreads on other bonds of similar, lesser or greater riskiness – whether the bond is rich or cheap.

Now let's apply the same process to a stock, or the stock market. First, compute the prospective return on the stock. Oh yeah; right. There's no way to do that. Or rather there is, but it requires one to either (a) make an assumption about the growth rate of earnings per share to infinity or (b) make an assumption about the growth rate of earnings for a number of years and also the terminal p/e ratio that the market will apply to e.p.s. at the end of that period (which in turn will be a function of the growth of earnings from then to infinity). **In other words, a simple mathematical calculation will tell us exactly what the promised return on a bond is (albeit not the probability that it will be received), while coming up with the future return for a stock requires making some massive guesses about the far-off future. That difference – in a nutshell – encapsulates a lot of the fundamental difference between investing in stocks and bonds.**

The bottom line: given that it's impossible to say with any accuracy what return a stock or the stock market will deliver, it's equally impossible to say what the prospective equity risk premium is. **The historic excess of stock returns over the risk-free rate may tell you the answer according to definition number one, with relevance depending on which period you choose, but it doesn't say anything about the other three . . . and especially not number four: the margin by which equity returns will exceed the risk-free rate in the future.**

Another Call for Counter-Intuitiveness

Many of the important things about investing are counterintuitive. Low-quality assets can be safer than high-quality assets. Things get riskier as they become more highly respected (and thus appreciate). There can be more risk in thinking you know something than in accepting that you don't. This counter-intuitiveness is a favorite theme of mine.

And the theme is importantly at work with regard to the equity risk premium, and especially *P&I*'s use of the term. I take great issue with their statement "The long-term equity risk premium is typically between 4.5% and 5%." **That may be what it "was" or "has been," but it doesn't tell us anything about what it "is" or "will be."** We know we can't extrapolate returns on bonds or the risk-free asset from the past; certainly changes in interest rates over the last five years mean investors in these things will enjoy far lower returns in the years ahead than they used to. **So then is it possible to know what we will get from equities? Or from equities relative to bonds or the risk-free rate? Clearly not. Thus I think it's dangerously misleading to say what the risk premium "is."** That's probably enough on this subject.

Let's move on to the final bullet point on page one and its reference to "the rising equity premium." The article discusses the case for an attractive equity risk premium in terms of definition number one – historically superior performance – since it goes on to point out that stocks outperformed bonds by an unusually large margin in the six months ended January 31, 2013 (11.23% for the Russell 3000 versus -0.29% for the Barclays Capital U.S. Aggregate Bond Index). But do six months of good performance say anything about a rising equity premium? And do they tell us anything at all about the future?

Well, the answer to the first question lies in which definition you're following. Of course the data tells us what the relative performance was (and 2012 was a great year, for example, with the S&P 500 up roughly 16% while the risk-less rate was close to zero). An equity risk premium defined this way is certainly in the best part of the historic distribution. But it tells us little about investors' past or present demanded returns. And what does it say about the prospects for continued outperformance?

To me, the answer is simple: the better returns have been, the less likely they are – all other things being equal – to be good in the future. Generally speaking, I view an asset as having a certain quantum of return potential over its lifetime. The foundation for its return comes from its ability to produce cash flow. To that base number we should add further return potential if the asset is undervalued and thus can be expected to appreciate to fair value, and we should reduce our view of its return potential if it is overvalued and thus can be expected to decline to fair value.

So – again all other things being equal – when the yearly return on an asset exceeds the rate at which it produces cash flow (or at which the cash flow grows), the excess of the appreciation over that associated with its cash flow should be viewed as either reducing the amount of its undervaluation (and thus reducing the expectable appreciation) or increasing its overvaluation (and thus increasing the price decline which is likely). The simplest example is a 5% bond. Let's say a 5% bond at a given price below par has a 7% expected return (or yield to maturity) over its remaining life. If the bond returns 15% in the next twelve months, the expected return over its then-remaining life will be less than 7%. An above-trend year has borrowed from the remaining potential. The math is simplest with bonds (as always), but the principle is the same if you own stocks, companies or income-producing real estate.

In other words, appreciation at a rate in excess of the cash flow growth accelerates into the present some appreciation that otherwise might have happened in the future. Or to paraphrase Warren Buffett, "when people forget that corporate profits are unlikely to grow faster than 6% per year, they tend to get into trouble." I doubt he intended anything special about 6%, but rather a reminder that when assets appreciate faster than the rate at which their value grows, it isn't just a windfall but also a warning sign.

Let's take a look at the 1990s, a decade full of lessons about equities. As of 1990, the historic return on equities stood at 9% or 10%, and for that reason attitudes toward them were generally favorable, with that 9-10% return expected to repeat in future decades. But the '90s were a salutary period in terms of economic growth, corporate performance, technological and productivity gains, declining interest rates, low inflation and relative peace in the world (as well as naïve optimism regarding the benefits of a credit-

fueled expansion, the profit potential of e-commerce companies, and the extent to which equity gains could be perpetuated). As a result, equity returns averaged 20% per year over the decade.

What was investors' response? They ratcheted up their expectations. I believe by 2000 the professional consensus for future equity returns had risen from the 9-10% range to 11%. A decade of the highest returns in history had convinced people that more good years lay ahead. Few people seemed concerned that the extraordinary returns of the 1990s might have borrowed from the 2000s (as certainly seems to have been the case in retrospect). As a result, just when stock prices were reaching levels they wouldn't see again for more than a decade, bonds were being dumped so that equity allocations could be expanded to all-time highs.

When I look at the *P&I* article, I see a statement that the equity risk premium is on the rise, but not a lot of reason why equities will do better in the future than they have in the past (or even specific mention of which past they'll do better than). **Extrapolation or analysis? They're two very different things.**

Valuing Stocks Today

The underlying reason it took so little from *FierceFinance* to get me going on this memo is that I had a lot of pent-up thoughts about equities and their current valuation. That's what the following pages will be spent on.

Ironically given the extent to which I railed above about limiting the importance attached to the equity risk premium, some of the strongest arguments for stocks today surround their relative earning power. In view of the difficulty in quantifying the prospective returns on stocks, appraising their value relative to bonds or the risk-free asset is often best done through comparing their yields.

Since most companies pay out a modest percentage of their earnings, dividend yields greatly understate companies' ability to earn money for their shareholders, and thus for their stocks to appreciate. A better measure of stocks' long-term potential may be found in their "earnings yield." The earnings yield is the reciprocal of the p/e ratio: the e/p ratio or ratio of earnings to price. To gauge relative price-attractiveness, it isn't unreasonable to compare the earnings yield on a stock against the yield on a bond (or against the risk-free rate).

Let's review a few data points:

- If the post-WWII average p/e ratio on equities was something like 16 (for an e/p ratio of 1/16, or an earnings yield of about 6.25%) and if I guess at a "normal" risk-free rate of 3%, we get a historic yield differential – we might call it the equity risk premium, defined this way – of 3.25% (6.25% minus 3.00%), or 325 basis points. The ratio between the yields was 6.25%/3.00%, or 2.08x.
- At the high in 2000, the p/e ratio on the S&P 500 was more like 32 (for an e/p ratio of 1/32, or an earnings yield of 3.12%), and the 30-day T-bill rate was probably 2%. In that case the yield differential or equity risk premium was a skimpy 1.12% (3.12% minus 2.00%), or 112 basis points, and the ratio of the two was only 3.12%/2.00%, or 1.56x. In other words, stocks didn't offer enough relative to fixed income, and that's the main reason why they've performed so poorly – both in absolute terms and relative to bonds – over the thirteen years since.

- Where are we today? The p/e ratio on the S&P 500 is back to about 16, meaning the earnings yield is 6.25% once again. I'll use a 30-day T-bill rate of 1.00% (it's actually closer to zero, but a yield ratio approaching infinity wouldn't be meaningful). That gives us a yield differential of 5.25% (6.25% minus 1.00%), or 525 basis points, and a yield ratio of 6.25%/1.00%, or 6.25x.

So let's recap:

	Post-WWII Norm	2000	Today
Yield differential	325 b.p.	112 b.p.	525 b.p.
Yield Ratio	2.08x	1.56x	6.25x

Certainly the yield comparison is highly favorable for stocks today. In fact it's one of the best in the last century (probably barring only the early 1980s, when the p/e ratio on the S&P 500 fell to mid-single digits). Is that the whole story? It never is; nothing's that simple, especially in the world of investing.

The problem with basing a pro-equities argument on the yield comparison is that most of equities' current attraction on that basis comes from the lowness of interest rates. Just about everyone knows (a) interest rates are artificially low because of central banks' efforts at stimulus and (b) rates will be considerably higher at some point in the intermediate term. In that case, rising rates would render stocks less attractive (all other things being equal, but they're not – see below).

The Other Pros and Cons of Equities

There are many ways to view valuation, and many elements in the current debate over equities. Here are a few of them (I'll start by reiterating the above for the sake of completeness):

- The differential between the S&P earnings yield and the risk-free rate or the yields on bonds – and their ratio – makes stocks look extremely cheap. PRO
- The attractiveness of these relative valuation parameters is highly dependent on interest rates staying low. CON (or LESS PRO)
- Relative to normal post-WWII p/e ratios, stock prices are average to slightly low as a multiple of projected earnings for the year ahead. PRO
- Robert Schiller's cycle-adjusted p/e ratios are gaining increased attention, and they suggest full rather than fair valuations. CON
- Arguably earnings growth in the years ahead will be slower than that which prevailed in the decades following WWII. Thus the post-war valuation norms are too high under the changed circumstances and should be discounted. CON
- The outlook for earnings is restrained by the questionable macro environment, including the challenges in restarting growth and the dire prognosis for the federal deficit. These problems may not be easily solved. CON
- Among the things keeping earnings high – and thus making stocks seem attractive – are some of the highest profit margins in history. If profit margins were to move toward normal levels, this

would bring down earnings, either taking stock prices down with them or lifting p/e ratios and thus reducing stocks' attractiveness. CON

- Corporate cash hoards are high, implying some combination of safety, potential for stock buybacks, and possible dividend increases. These are all good for shareholders. PRO
- Investor attitudes toward stocks remain tepid (see below). PRO
- However, with the S&P 500 up 16% last year and 10% so far this year, it can't be argued that stocks have been overlooked and or that attitudes towards them are still mired in the doldrums. CON

The Role of Investor Attitudes

I covered this subject at length in "Déjà Vu All Over Again" (March 19, 2012). I'm not going to drag you through it again, but I will copy over parts of that memo from a year ago:

. . . people have been throwing in the towel and selling stocks. Other things have come into vogue, attracting the capital that used to be invested in stocks. Mutual fund investors have turned their attention elsewhere. . . . Stocks have gone through a decade in which their absolute return was negligible and their real return was negative. . . . They face a litany of negatives, without any real possibility of relief . . .

The negative factors are clear to the average investor. And from them he draws negative conclusions. But the person who applies logic and insight, rather than superficial views and emotion, sees something very different.

He sees an asset class that is unloved. He sees stocks that have cheapened for a decade – once dividends have been subtracted from the returns, and especially when prices are viewed relative to earnings. He sees securities that are priced below the value of the underlying assets on which they have a claim. He sees outflows of capital that, rather than being a negative, have lowered prices and can give rise to a strong price rebound when and if they reverse. Most of all, he sees an asset class to which no optimism is being applied. . . .

The thing to notice about the preceding paragraphs is that when I wrote them a year ago, I didn't do so to describe then-current market conditions. Rather, I was trying to capture conditions as they were in 1982, when *Business Week* magazine carried a cover story trumpeting "The Death of Equities." My point was that in 1982, overly negative investors were fixated on the reasons for continued lethargy on the part of stocks, just when the scene was set for the greatest upsurge in stock market history.

. . . As something goes in one direction for a while, people conclude increasingly that it always will . . . often just when the likelihood grows that it will reverse instead. And that was the greatest shortcoming of "The Death of Equities." **The extrapolator threw in the towel on stocks, just as the time was right for the contrarian to turn optimistic. And it will always be so.**

I didn't think last year that the extent of the undervaluation was anywhere as great as it had been in 1982, but I did think the conditions were similar in kind. Nothing sets the stage for an upturn as well as excessive negativism – or at minimum excessive disinterest. And that's what I sensed in the stock market last year, following on the heels of a twelve-year malaise. Thus I don't consider it a freak occurrence that stocks all around the world went on to have an excellent year in 2012.

Many conditions remain similar . . . again, in kind. Equity mutual funds are seeing only modest inflows, albeit the outflows have stopped. Even though they've appreciated, stocks still aren't highly valued. Many institutions have allocations to equities that are well below the average of the last fifty years, and no one's rushing to move them up. In other words, I'm comfortable saying attitudes toward equities are characterized by relative disinterest and apathy.

This is certainly something that can turn. If it turns, it can have a significant impact. And what is most likely to turn it? It won't necessarily take a "grand bargain" in Washington to solve the nation's fiscal problems, or a sudden rebirth of economic growth worldwide, or the invention of the next iPhone. All that's required is another good year or two for stocks and a switch in investor psychology from "stocks are unlikely to do anything but extend the 'lost decade' " to "hey, I'm afraid I might not be positioned adequately to participate in the next bull market."

A move upward can be powered by a switch from the fear of losing money to the fear of missing opportunity. When attitudes are moderate and allocations are low, it doesn't take much.

* * *

In the mid-1970s I was fortunate to happen upon one of the first of the time-worn pearls of wisdom that contributed so much to my education as an investor. It described the three stages of a bull market:

- the first, when a few forward-looking people begin to believe things will get better,
- the second, when most investors realize improvement is actually underway, and
- the third, when everyone's sure things will get better forever.

In "The Tide Goes Out," written in March 2008, several months before the lows of the financial crisis, I applied the same thinking to the converse – the three stages of a bear market:

- the first, when just a few prudent investors recognize that, despite the prevailing bullishness, things won't always be rosy,
- the second, when most investors recognize things are deteriorating, and
- the third, when everyone's convinced things can only get worse.

Hindsight always makes it clear what was going on at a particular point in time. It's a snap now to say the second quarter of 2007 marked the third stage of a bull market: no one could think of a way to lose money. And in the fourth quarter of 2008 (for credit) and the first quarter of 2009 (for equities), we were certainly in the third stage of a bear market: most people thought the financial system was about to collapse, and securities that had halved in price could do nothing but halve again.

But the study of market history only makes us better investors if it teaches us how to assess conditions as they are, rather than in retrospect. When I wrote "Déjà Vu All Over Again" a year ago, it was my feeling that equities were in the first stage of a bull market. Experience had been so bad for so

long – and the level of disinterest was so high – that only a few investors thought equities could ever catch on again. Those low expectations, when combined with modest fundamental and psychological improvement, gave the S&P 500 a return of about 13% over the year since that memo was written.

So now we have a somewhat improved fundamental environment, a generally more optimistic group of investors, and stock prices that are a fair bit higher. **No one should say the likelihood of improvement is entirely unrecognized today, as would have to be the case for this to still be stage one. I think the existence of improvement is generally accepted, but that acceptance is neither extremely widespread nor terribly overdone. Thus I'd say we're somewhere in the first half of stage two. Pessimists no longer control market prices, but certainly neither have carefree optimists taken over.**

* * *

A great rotation? Maybe . . . or maybe not. Nowadays pundits and the media are quick to come up with cute labels – usually just the right size for a headline or sound bite – to describe things that are taking place or that “everyone knows” are just around the corner. **I don't know whether it's going to be great. Heck, I don't even know if it'll happen.** But I like to enumerate the pros and cons and try to put them in perspective, as much as I like skewering excessive generalizations and pat pronouncements.

Of course, doing that isn't enough. I feel I should come down on one side or the other. **Thus I'm quite comfortable imagining a few years of equity performance that provide a pleasant surprise relative to what I think is the prevailing expectation of 6% or so per year.**

And if I'm wrong – if there is no rotation from fixed income to stocks – I'm not that worried that I'll end up with great regret over having failed to pile into T-bills yielding zero or the 10-year note guaranteeing 2.0%. When attitudes are moderate and allocations are low, like I feel is currently the case with equities, there's little likelihood of investing being a big mistake. And when interest rates are among the lowest in history, it would take deflation, depression or calamity to make failing to invest in Treasuries and high grade bonds a serious omission.

March 13, 2013

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