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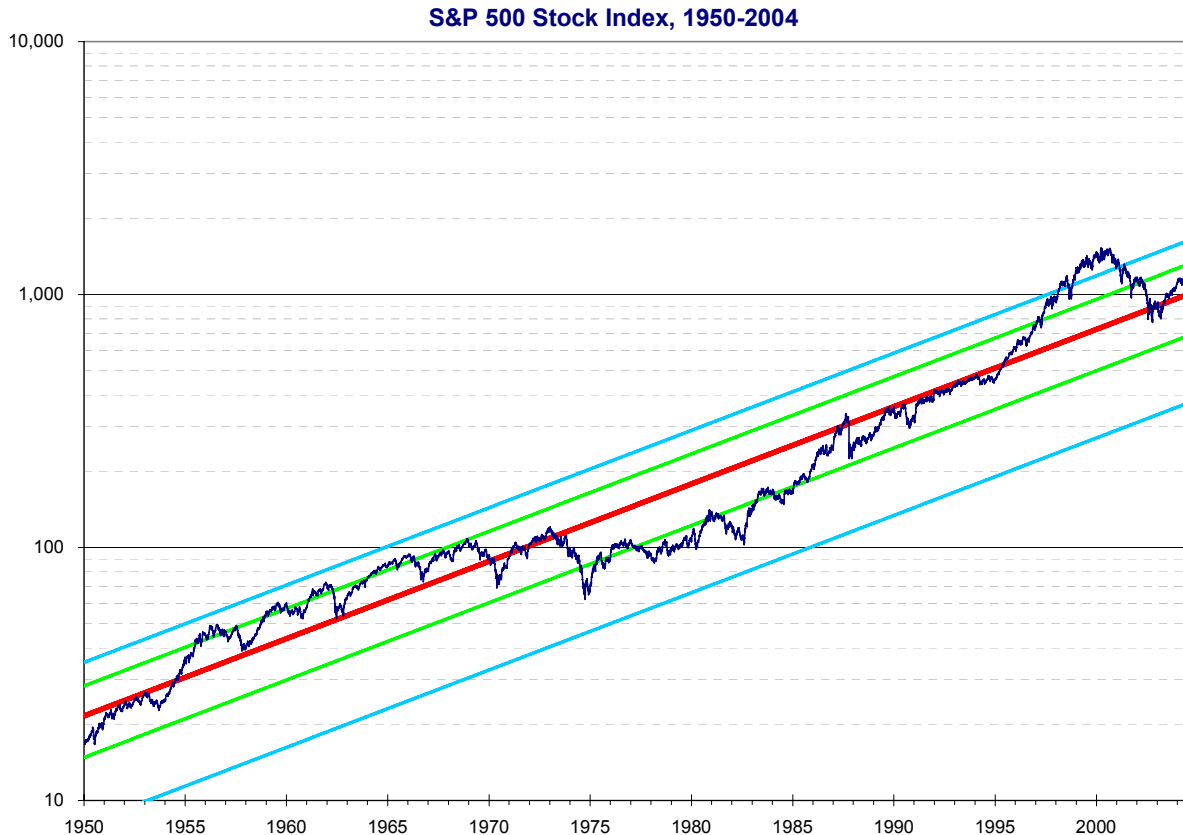
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Swimming the Market Channel



Over the long term, U.S. stock market indices like the Dow Industrials and the S&P 500 have risen meaningfully — primarily reflecting real (inflation-adjusted) growth in the U.S. economy plus the impact of inflation. (The combined impact of real growth and inflation is reflected in the statistical measure known as 'nominal' GDP.) Interestingly, while the rate of growth of nominal GDP has fluctuated within a relatively narrow range, the rate of growth of stock prices has fluctuated much more significantly — primarily as a result of swings in investor optimism and pessimism. Although these swings in investor sentiment are largely unrelated (and disproportionate) to changes in nominal GDP growth, the fact remains that investor sentiment has been quite volatile. Above, we show a history of the S&P 500 stock index since 1950, together with a (red) line showing the S&P 500's trend over this period. In addition, there are two sets of 'channel' lines (green and blue). The green-lined channel was selected to contain the actual S&P 500 index approximately two-thirds of the time, and the blue-lined channel contains the S&P 500 about 95% of the time. (The statistically oriented among our readers will recognize that the green lines represent a one standard deviation band, and the blue lines reflect a two standard deviation band.)

The trend line (red) increases at a 7.3% annual rate, and it appears as a straight line on a logarithmic axis — as in our chart. (Actual S&P 500 total returns over the 1950–2004 period were above 10% — the chart shows only price growth, not dividends.) As we consider this chart, a number of important observations come to mind.

First, and perhaps most obvious, the upward-sloping channel of stock prices is quite wide. Indeed, at today's S&P 500 level (approximately 1,100), the one standard deviation channel is over 600 points wide. (This same channel for the Dow Industrials would be about 6,000 points wide.) Put differently, if the S&P 500 moved from its present level (above its long-term trend) to the upper one standard deviation channel limit, it would rise 22%, and if the S&P 500 declined to the lower one standard deviation channel limit, it would decline 36%. (Remember that the one standard deviation channel historically contains only two-thirds of the actual values of the S&P 500.) Thus, without any change in present economic conditions or in the long-term outlook for the U.S. economy or stock prices, the S&P 500 could be significantly higher or lower than its present level, based on historical precedent.

Second, the S&P 500 is currently above its 1950–2004 trend. This strikes us as representing an element of valuation risk, and it's the reason why we do not view S&P 500 indexing as an especially attractive choice for investors at this time.

Third, relative to its long-term trend, the S&P 500 was the most extremely priced in the late 1990s, when it significantly exceeded its two standard deviation channel. (Not surprisingly, the popularity of indexing peaked in the late 1990s — likely contributing to the very high S&P 500 prices of that time.) As many investors who bought index funds in the late 1990s now appreciate, unless the S&P 500 index revisits the rarely-reached upper two standard deviation channel boundary, it may take a long time before they realize a meaningful return on their index fund purchases.

Finally, it's generally best to invest in stocks when their prices are below their long-term trend, and it's best to be cautious when stock prices are above their long-term trend. Unfortunately, above average sentiment (like below average sentiment) can and has persisted for years at a time — so if one's only choice of investment is the S&P 500, it may be inappropriate to invest for a number of years. Fortunately, there is an alternative to swimming the wide market channel. Our approach to investing is not to focus on the S&P 500, but rather to identify a suitable number of individual stocks that appear to be selling below their intrinsic values. Indeed, given the thousands of publicly traded stocks available for investment, it is possible to find attractive investments in most market environments — even when the S&P 500 is above its long-term trend.

In short, while throwing darts or investing in an index fund may work out fine when the majority of stocks are near or below their long-term trend prices, if investors want to own attractively priced stocks in most environments, they need to be very selective in their choices. As the reader knows, the intelligent way to invest selectively is to conduct careful, detailed and independent research. While this is easy to say, it's quite difficult for most investors to do.