

## **The Boomers' Dilemma**

Even though the market delivered a substantial recovery last quarter, the market was down for the second year in a row. For the years 2000 and 2001, the S&P 500 returned -9.2% and -11.9%, respectively, or -20.0% for the two-year period. While CornerCap's returns have been up nicely over this time, most investors have suffered, and some have lost over half of their stock market investments. These recent tragedies are important, but we must always be moving on to something more important — the future.

What is going to happen to the investment markets over the next few years? As our long-time clients know, we are not much on forecasting. But, as they also know, our commentaries frequently state our strong opinions about the valuations of the market, behavior of investors, and the economic implications, which are forecasts in effect. We have been pretty good with the bubbles, having accurately called both the oil bubble of 1980 and the technology bubble of 2000, and of much greater importance, we made investment decisions to capitalize on those market extremes. But the bubble has burst (or is still bursting), so what comes next?

### **The Savings Problem**

From their very beginnings, the baby boomers' influence on our economy has been dramatic. There are 76 million people in the boomer generation — people from 37 to 55 years of age. Over the last 30+ years, we have followed them through diapers, trend-setting stores, illegal drugs, sporty autos, child care for working moms, improved housing, fast foods at home and away from home, etc. Over the next 30+ years, we will follow them through the discount stores, legal drugs, basic transportation, and retirement food and housing. These are very long-term, gradual trends, but we as investors must be aware of the changing spending patterns that result.

As important as the spending patterns are for these boomers, the savings trends are equally important. The boomers have not been savers. Their savings rate is essentially nonexistent. Consumer debt has risen to an all-time high. The continued availability of credit, even in the middle of a recession, combined with the Fed-induced lure of lower interest rates, has resulted in a mountain of consumer debt. With consumers' income being diverted to repay this debt, in addition to their continued need to buy goods and services, how much will be left over for increased savings?

As the market price/earnings multiples went from below ten in the early '80s to the mid-thirties in the late '90s, many boomers assumed that they could avoid saving because they would be "saved" by the market — not a good assumption. The boomers are continuing to hold on to that hope. That hope is fed by occasional market pops like the one we saw last quarter. The market will not save the boomers. The bottom line is that they do not have enough money to retire.

How will the boomers solve this enormous problem? To some degree, they will find a way to increase their savings rate over the coming decades. But, to a much greater degree, they will deal with their lifestyle in their senior years the same way they dealt with their lifestyle in their earlier years — more work. In their earlier years, the progression of the working mom produced the added resources needed to provide an acceptable lifestyle. In their senior years, the working retiree will provide the additional resources needed. We will simply have fewer early retirees and more Wal-Mart greeters.

## **The Investment Problem**

No one wants to burst anyone's bubble. In fact, it is not good business, especially when you are an investment adviser. Just read or watch the many market prognosticators who promote fantasy to the buying public on a daily basis. No one wanted to hear about a bubble two years ago, and they do not want to hear about one now. But, one cannot be successful as an investor if he denies reality in favor of fantasy. The reality is that there is a bubble still present in the market, differently clad than the tech-bubble, but it has the same potential for creating problems for investors in the coming years.

The characterization of this bubble is based on a few investment principles that are time tested and cannot be disputed, at least not in our mind. First, stock market returns are a function of just two things: Stock appreciation (future growth) and dividends paid (current yield). Over the long term, both of these return items will be derived from corporate earnings. Of course, over shorter periods of time, market mania can make anything happen to stock prices. Since we have no clue what the masses might decide to do in the near term, we will just address what we know, which is that the long-term market will be determined by what happens to corporate profits.

We have good news. Long-term corporate profits are not that difficult to forecast. Studies have shown that corporate earnings grow at something close to the rate of GDP growth. The best economic environment for GDP (and earnings) growth is low inflation, and in that environment the best we can expect is a growth in the range of 6% to 6.5%. To use this rate as our earnings forecast would be optimistic for a couple of reasons. First, there is no guarantee that our economy will be able to sustain the current low inflation, optimal environment. Second, earnings growth has actually slightly lagged GDP growth over the years. According to a study by Rob Arnott of First Quadrant, this lag effect relates to the portion of GDP growth that comes from new business enterprises that are not available to the public market.

The other element in our stock market return is dividends. Dividend yields for the market have declined from over 6% in 1982 to around 1.4% now. Add this dividend yield to our growth forecast presented above, and we have a long-term forecast for stock market returns of 7.5% to 8%. Is this around what you expect? What are the media-prevalent market analysts saying? Over the last two years, would not you say that most of them have significantly lowered their forecasts from 15% to 18% down to a more "conservative" 10% to 13%? The difference between our forecast and their hope-based forecast is huge, and it has dramatic implications, especially for our baby boomers. Maybe we are still missing something.

Oh yes, we are missing something. What you have to pay for something is always important—a lesson only recently learned by many investors. What are we currently paying for the earnings of "the market," and is it too high, too low, or just about right? The market (S&P 500) is currently priced in the range of 30 to 35 times earnings. This is at the high end of any historical levels. However, many analysts tell us that this multiple may be reasonable considering the current and projected modest levels of inflation (1% to 2%) and the low yields on bonds, the primary alternative investment that competes with stocks. Inflation and bond yields tend to be inversely correlated to price/earnings multiples, so higher-than-average multiples are certainly justified at this time. While we may be able to justify (or rationalize) the current multiples for the market, there is no justification for a further multiple expansion from this point. Investors' returns will come solely from earnings growth and dividends.

## **Dealing with the Dilemma**

The starting point for dealing with the boomers' dilemma is to take a realistic view of the future. Expectations for what the investment market will be able to deliver are still too high. Savings rates will be forcibly increased. Spending/savings pressures on individuals, under-funded corporate plans, and belated legislative incentives will begin to chip away at the problem. The sooner these initiatives happen the better, so that the power of compounding can have a more material effect.

In the investment area, we believe that CornerCap will be able to deliver returns in excess of the 7.5% to 8% market forecast over the next decade. First, there are many stock growth opportunities available in the market that are not priced at 30 times earnings. We believe that our disciplined investment process that incorporates both earnings multiples and earnings growth give us a permanent advantage, resulting in long-term returns in excess of the market.

Secondly, the capitalization-weighted indices (e.g., S&P 500) went through an 18-year period when multiples expanded from eight times earnings to over thirty times earnings. Because of the multiple expansions of these mega-cap stocks, the capitalization-weighted indices have been difficult for most investors to outperform over this period. This has not been the case over the last two years, and we believe that the capitalization-weighted indices will become relatively easy to outperform over the coming years. Reversion-to-the-mean is a powerful force, even when the cycles extend over multiple decades.