Happy New Year. In this note, we present our view on market returns, both historical and prospective.

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HOW DID THE MARKET GET HERE?

The average total return for the S&P 500 for the last 50 years has been slightly over 11% per year, or about 7%, not counting inflation. Over the period, corporate net profit margins and the share of revenue and profits attributed to publicly traded companies have increased. It has been an extraordinary period, and it raises two questions. First, what conditions led to the high return? Second, where are we going next?

Total return for the S&P 500 Index comprises dividends returned to shareholders and increases in the index's price per share. Our analysis concludes that approximately 90% of the price increase resulted from growth of the index's Earnings Per Share (EPS), with the rest related to an expansion of the price/earnings multiple.

Further, we break down increases in EPS into three buckets: Reinvested earnings, Inflation (CPI), and Shrinkage. For the last half-century, the S&P 500 index earnings growth (6.7%) has averaged about 1% less per year than the sum of retained earnings (3.9%) and CPI (4%) which we consider shrinkage. Individual companies can also impact growth by issuing additional shares or debt.

Investment Components Last 50 Years

	AVERAGE	STANDARD DEVIATION
TEN YEAR TREASURY	5.84%	2.75%
CPI (Inflation)	4.01%	2.82%
Real Return	1.83%	1.54%
S&P 500 INDEX		
Earnings	6.73%	16.00%
Retained Earnings	3.94%	1.52%
CPI (Consumer Price Index)	4.01%	2.82%
Shrinkage	-1.21%	
Dividends	2.80%	1.20%
Multiple	1.15%	21.96%
Total Return	11.08%	17.40%
Real Return	6.92%	17.77%

Because the S&P 500 index revenue has grown faster than nominal GDP and profit margins have increased, we don't attribute shrinkage to the CPI bucket. Share and debt issuance (treasury activities) could be a part of the explanation, but we believe the big drag on the Index's returns was underproductive retained earnings. We conclude that as much as 25% of retained earnings would have been more productive if paid out as dividends.

Paid dividends are cash in hand, and historically, these dividends have been much less volatile than price returns. In our view, companies that are profitable enough to pay dividends to shareholders are often more efficient with shareholders' capital, and more predictable.

WHERE ARE WE GOING?

This brings us to four basic conclusions based on current interest rate levels, valuations, dividend policies, and our inflation forecast, which is modestly above the Fed's 2% target.

1. Average large-cap U.S. equity market returns are likely to be less than long-term averages, but parts of the market can do relatively well.
2. Higher long-term interest rates favor less volatile dividend payers and businesses with improving returns on invested capital.
3. Bond's higher yield and lower volatility have improved their relative risk-adjusted returns versus equities.
4. The risks of policy mistakes by the Federal Reserve, Executive Branch, and Congress are all relatively high.

Looking forward to our next conversation,

Joe, Jim, Ernie and Rusty

Please read the following one-page note with tips on how to protect yourself online. We will be posting this note and additional resources on www.apricuswealth.com. Please let us know if you have an idea you would like us to explain.

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