EPIC
Investment Management, Inc.

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Own Equities

We begin with the briefest of overviews, a quick reminder of the four parts to our Investment Philosophy and Strategy:

1. Diversify -- within and across asset classes
2. Own Equities -- our core competency and belief
3. Dual Target -- own both good companies and good stocks
4. Sell Discipline -- a critical last component

Over time we will expound on each of these ideas. In this issue, we focus on our core competency and strongest belief -- owning equities. Why our strongest belief? Stocks, over time, represent the best means for investors to create wealth, and have outperformed virtually all investable asset classes. History teaches us this much, but is learning a statistical fact a guarantee of future results? Don't outcomes change over time? Fair enough, learning the past only goes so far in assessing the future; understanding context provides much greater insight into financial history's ongoing relevance.

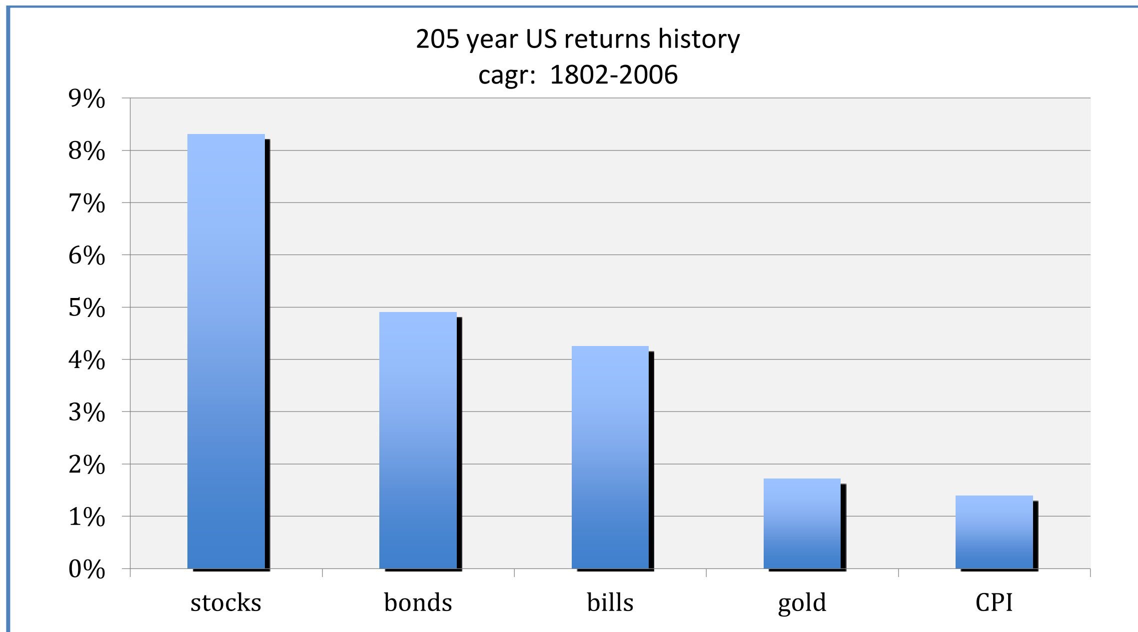
Let's deconstruct long-term stock market performance. Taking some latitude, we can say the US economy is capable of sustaining annual real growth of three percent. Tack on another three percent for inflation, and the economy produces six percent nominal growth per year. Corporate America should be able to match this, generating six percent annual earnings growth. If we add in another two or three percent from dividends, and assume no multiple expansion, shareholders should attain a long-term annual price appreciation of six percent, and a total return of eight to nine percent.

Is this realistic? Indeed it is. While these outcomes are not produced every year or every decade, within a reasonable margin, these are the results of the past two centuries; and since the roaring '20s; and for the past four decades and two decades. You get the picture.

The price of this substantial performance is high volatility(risk), but the trade-off is generally favorable -- more so now after a "lost-decade" for the US stock market, and a return to reasonable valuations. We will gladly run equity-only accounts for institutions and high net worth individuals who choose to diversify on their own. In managing blended accounts for individuals, equities typically represent a majority of each portfolio. To our thinking, justifiably so.

On the following pages we provide an overview of US stock market results for the past two centuries. We offer brief commentary to support, not a best case viewpoint -- investing is not about cheerleading -- but a reasoned assessment of the equity market.

Under The Buttonwood Tree



Source: "Stocks For The Long Run" -- J. Siegel 1

In 1792 a group of 24 prominent brokers and merchants gathered on Wall Street to sign the "Buttonwood Agreement", establishing what would become the New York Stock Exchange. At the time only five securities traded -- three government bonds and two bank stocks. One of those banks, Bank of the United States, lasted only 20 years, as Congress failed to renew its charter. The second, The Bank of New York, is still publicly traded. Today, for just $30, an investor can own a share of history -- New York City's first bank, an original lender to the US Treasury, a business founded by Alexander Hamilton, and a multi-billion dollar banking institution -- all rolled into one. 2

So we start from a very long-term perspective -- two centuries, as far back as the data takes us, and just ten years after the Buttonwood Agreement. The message over this timeframe is clear: over an extended horizon, stocks outperform virtually every investable asset class. Why? Because equities represent an ownership of businesses, which grow in value along with or in excess of the growth of the overall economy.

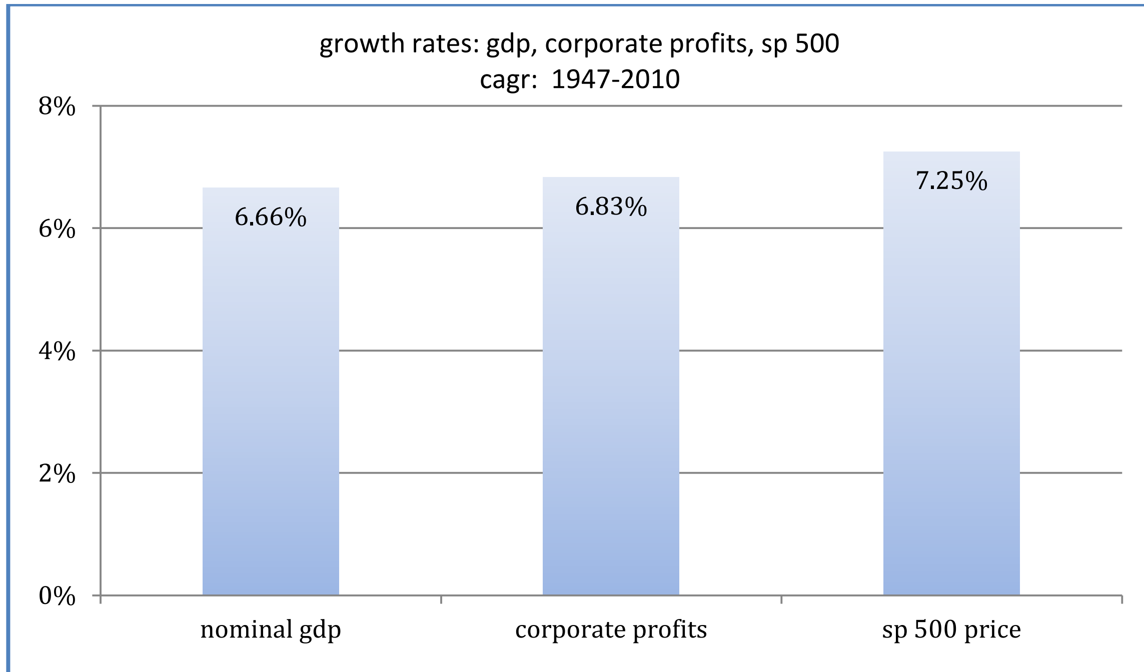
In comparison, bonds promise a fixed rate of interest and a future return of the initial investment, unadjusted for inflation. Bills over time offer liquidity and a variable rate of interest, nothing more. Gold and other commodities are dependent on both supply/demand dynamics throughout the world, and central bankers' resolve in maintaining the value of "fiat" currencies.

Real estate, in the long run, cannot appreciate substantially above the rate of growth of personal incomes. Otherwise real estate would become prohibitively expensive and collapse under its own weight.

The best means of growing capital -- accumulating wealth over the long term -- is through the ownership of successful businesses. Owning equities.

The Growth Connection

Provided next is a graphical representation of the relationship described earlier -- the long-term connection between economic expansion, earnings growth, and stock prices. The starting point of 1947 is chosen as the oldest date for which we have corporate profit figures.

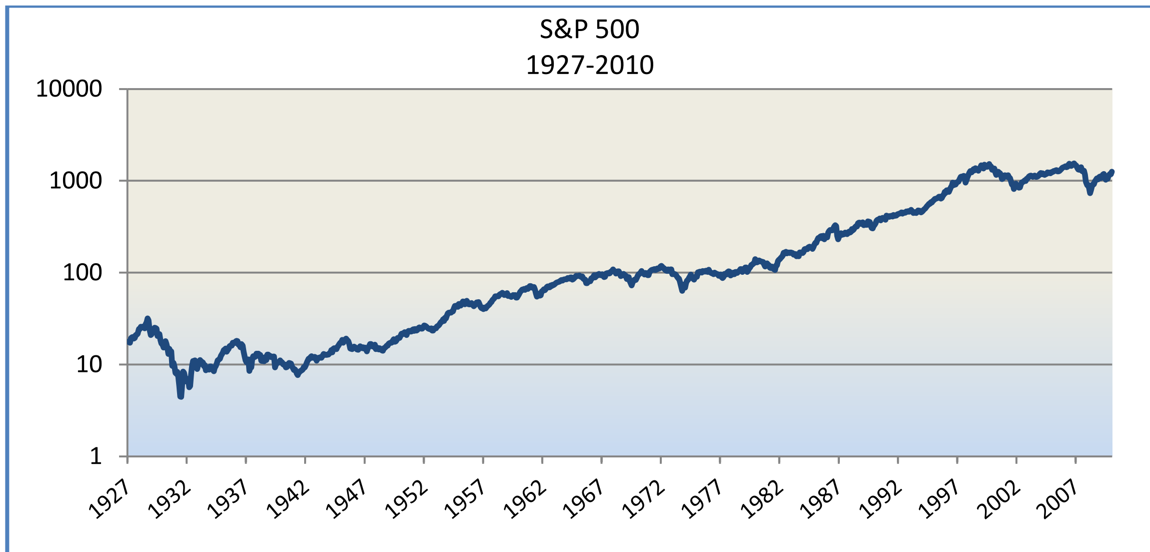


Results since 1947 show compound annual growth rates of 6.66% for nominal GDP, 6.83% for corporate profits, and 7.25% for the S&P 500 index. The growth in the S&P 500 index above and beyond corporate profit growth is a reflection of multiple expansion. In other words, stocks sell at higher valuations today than they did in 1947.

A word of caution is in order here. While the relationship between economic growth, corporate profits growth and equity returns is very strong over a long timeframe, it is much weaker over shorter time spans. Most recently, 2009 was a year of severe economic contraction, yet stock prices soared after bottoming in March, properly anticipating the future recovery. Even decade to decade, the relationship is tenuous. Equity returns have varied greatly across decades, much more than would be explained simply by economic expansion. Since the depression, the strongest decades of real economic growth have been the 1940s and the 1960s. Yet the strongest decades of equity returns have been the 1950s, 1980s and 1990s. Clearly something more is at work.

The explanation? While many variables may be considered, one critical element is valuation at the beginning of the measured cycle. In the early 1980s and 1990s, stock valuations were low, then reasonable. By the year 2000, valuations had formed a bubble, and subsequent returns were horrible. The overall message does not change; we just need to be careful about taking it too far.

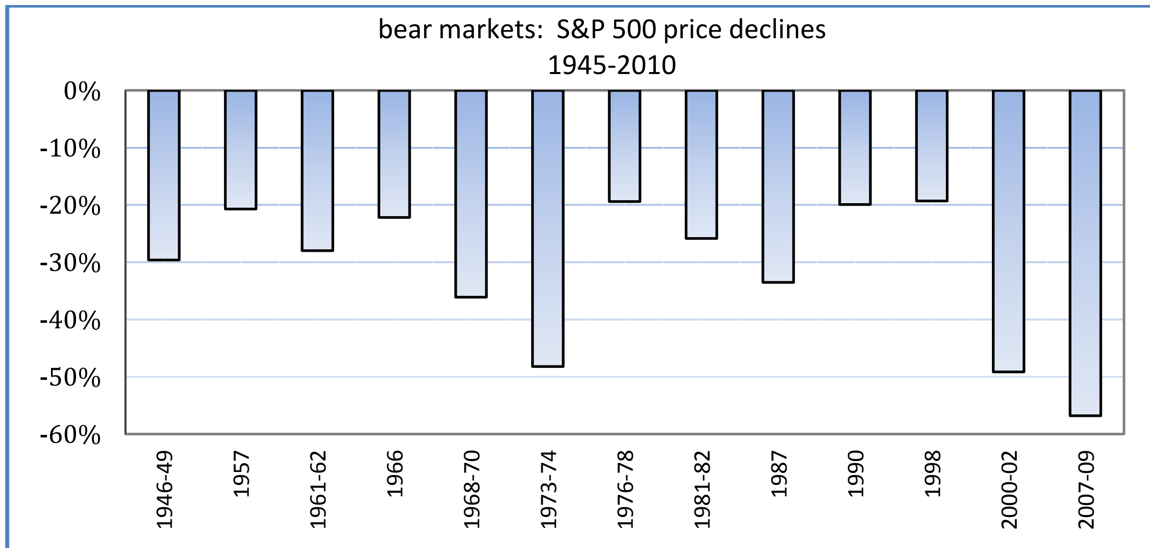
The Institutional Standard



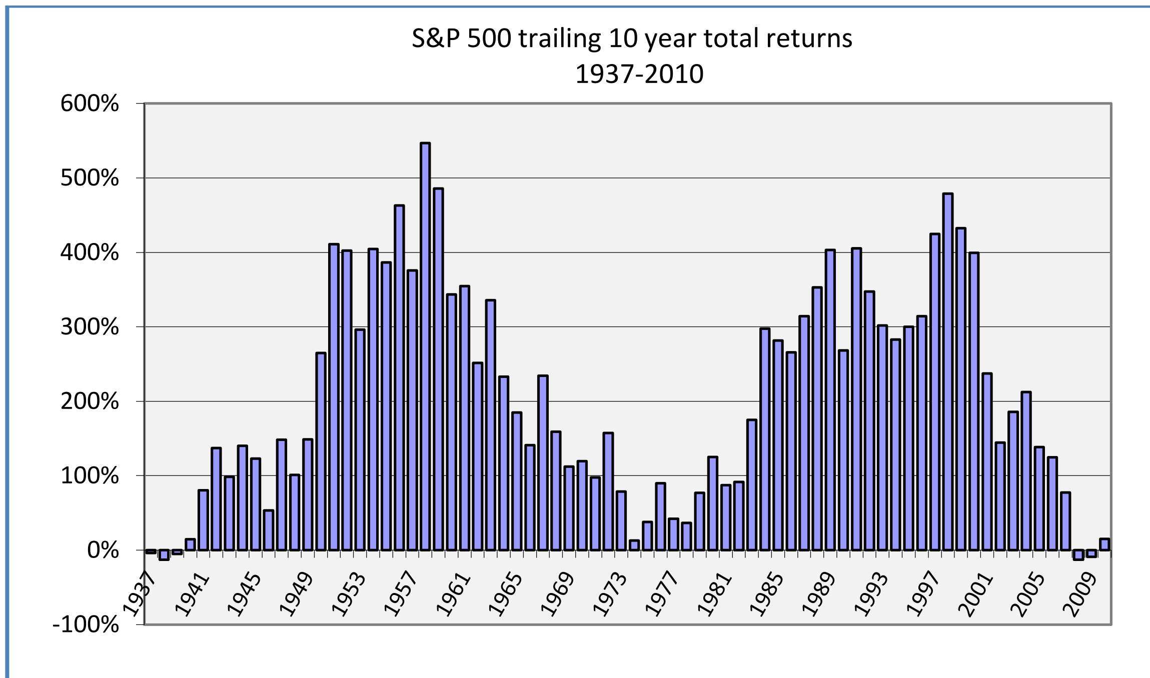
Standard Statistics created the first daily-tabulated "Composite Price Index" of 90 stocks in 1926. Fifteen years later, Standard Statistics merged with Poor's Publishing, creating the Standard and Poor's Corporation. In 1957 the S&P 500 Stock Index was introduced. Although not as widely quoted as the Dow Jones Industrial Average, the S&P 500, with its large number of stocks and market capitalization weighting, became an institutional benchmark. Utilizing the prior 90-stock Composite Price Index, the S&P 500 was computed back to the end of 1927. [3]

Since 1927, the S&P 500 index on a price-only basis has grown 70-fold. From its bottom in 1932, it has grown 280-fold. Adjusted for dividends, the total returns are much higher.

Long-term investors have been richly rewarded for owning stocks. But there is no free lunch: The price for this substantial performance is high volatility -- stocks bounce up and down in unpredictable fashion -- and bear markets may cut into investors' wealth to a painful degree.



Rolling Returns

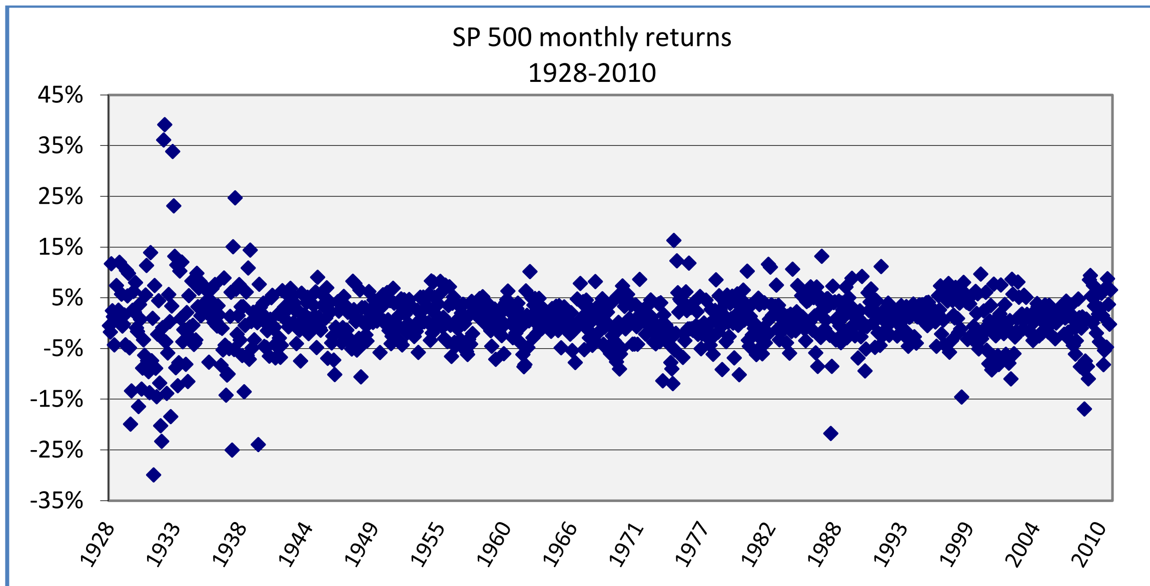


The recently completed decade proper -- the 2000s -- was the worst decade since the 1930s on at least two critical measures -- real economic growth, and stock market returns. Okay, but there are always the elements of chance and timing when looking at a specific decade. A more robust comparison is a rolling 10-year history, as provided above.

In the late 1930s, trailing 10-year equity returns were negative, reflecting severe bear market losses during the depression. Since 1940, S&P 500 rolling 10-year total returns have always been positive.. that is, until 2008 and 2009. Now after a lost decade of equity returns, the likelihood that this is a bad time to invest in stocks seems very low.

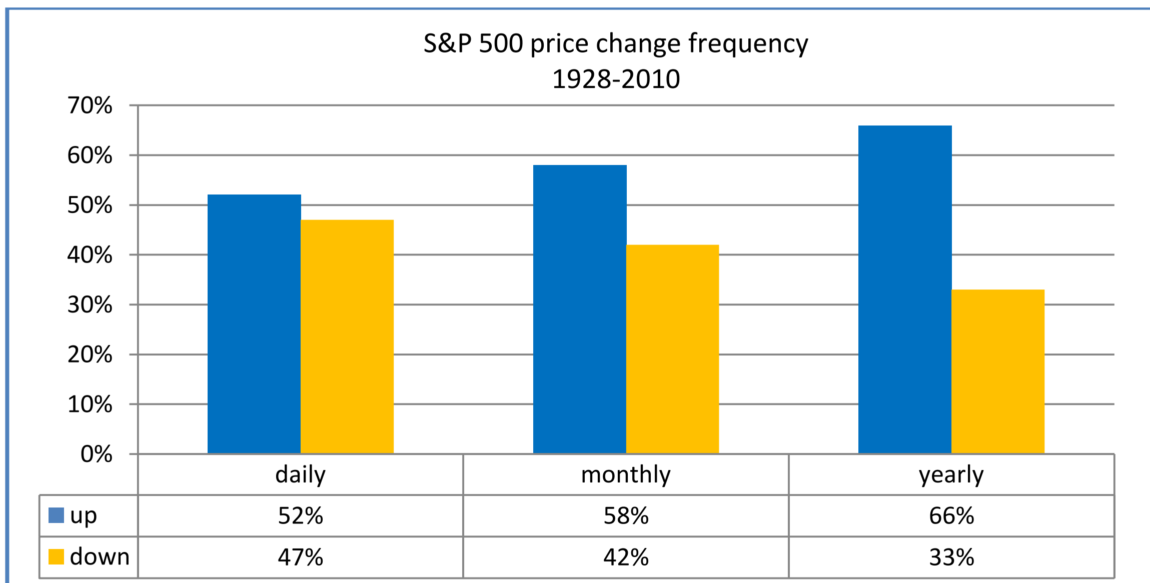
The concept of "reversion to the mean" is strongly favorable at this juncture in the market. On its own, the concept never offers compelling evidence. That is not its nature. Yet it does suggest that the odds, tilted against equities a decade back, have now turned favorable. As it so happens, this coincides with a far more reasonable valuation backdrop.

Inkblot Test



Looking at the above chart, what do we see? Is it an inkblot of random returns, a meaningless cluster of dots? Not quite. The scattergram of monthly returns has a deceptively favorable ratio of 58% positive to 42% negative, with an average return of 0.57%.

At first blush, it appears that monthly equity returns are volatile, random, and centered at zero. Yet only the volatile appearance is completely true. On average, the stock market rises nearly six of every ten months, while providing a meaningful positive return.



	daily	monthly	yearly
up	52%	58%	66%
down	47%	42%	33%

It is true that day to day, stock returns are nearly random.. 52% positive. Yet monthly returns are positive 58% of the time, and annual returns are positive 66% of the time. From unpredictable daily market moves, favorable long-term outcomes are created.

The House Advantage

At times, people jokingly refer to the stock market as a casino. It has been noted that the term "blue-chip" -- now meant to designate a large, quality company -- once referred to the highest-valued betting chip on a casino floor. The implication is that investing as shareholders in US companies over an intermediate or long time-frame is a form of gambling.

In fact, this is completely backward. Perpetual market skeptics, "perma-bears", are the casino gamblers, betting against the house advantage. They are consciously avoiding what has been the most rewarding long-term investment opportunity available to most people. If we ask these skeptics to name two investable asset classes that have outperformed equities over the long-term, they would be stymied. To the best of our knowledge, that challenge cannot be answered.

Looking objectively at financial history, this is what it teaches us:

- For decades and centuries, equities have provided among the highest investment returns of any asset.
- Equity returns have easily outpaced bonds, bills, gold, most forms of real estate, and have exceeded inflation rates by multiples.
- Stock prices have advanced two of every three years.
- The long-term connection between growth in the economy, profits, and stock prices is strong; the short-term connection is weak.
- In addition, stocks are liquid, carry low transaction costs, and are treated favorably by the tax man.
- The price of this significant performance is high volatility, and the risk of severe bear market losses.

With some limitations, this is a trade-off most investors should accept.
Stated simply, investors should own equities.. and we do.

Sources:
1. "Stocks For The Long Run" -- J. Siegel, 2007, McGraw-Hill Publishing
2. New York Stock Exchange, history
3. Standard & Poor's, historical timeline
4. All other data sources: Bloomberg

Tidbits..

US manufacturing jobs grow for the first time in 13 years.
For US economy, another small step in the right direction.

Apartment vacancies in US fall to two-year low.
A mixed bag, reflecting improving economy but weak demand for single family housing.

Wall Street Journal informal tally of consumer prices shows second year of 4%+ inflation.
Government will insist there is no inflation until it hits us between the eyes.

Illinois, facing budget crisis, raises personal income taxes by 67%, corporate taxes by 46%.
A sign of the times for many states, but don't count on a rate rollback anytime soon.

Stocks rated "sell" outperform stocks rated "buy" since market bottom, Bloomberg study says.
A recurring theme and food for thought: sell side analysts are not stock pickers, not investors.

IMF forecasts current year global growth of 4.4%, after 5% rise in 2010.
Hard to believe that 4.4% growth is considered somewhat disappointing.

White House proposes five-year freeze on non-discretionary, non-security spending.
More posturing and avoiding the real issue of overgrown entitlements.

CBO estimates current year fiscal deficit at $1.5 trillion, record level.
Staggering number, moving in the wrong direction, and still 10% of GDP.

JP Morgan to accept gold as collateral.
Better than greenbacks, so why not?

NYSE Euronext to merge with Deutsche Bourse AG.
Two centuries since the Buttonwood Agreement, change catches up with the Big Board.

Borders Group, nation's second largest bookstore chain, files bankruptcy.
For too many retailers, brick and mortar are now overhead burden.

Crude oil surges through $100 per barrel on Middle East upheaval.
The new reality: commodity prices are beyond our control.