

Introduction to Secular Bear Markets

While stock market movements often seem to have to no basis in reality, especially in the short term, there are only three factors driving stock market returns:

1. Dividends: The income generated by stocks adds to total return.
2. Earnings growth: The value of a stock can be viewed as a multiple of its earnings. As long as company earnings grow, even if the price-earnings ratio that investors place on that stock remains unchanged, the value of the stock increases.
3. Change in the Price-Earnings Ratio: Investors may be willing to pay a higher or lower price-earnings ratio tomorrow than today. If the price-earnings ratio increases, that increased valuation will contribute to total return.



Long term return history

We can quantify how each of these three components have contributed to stock market returns over time. For example, over the past approximately 100 years, stocks have delivered about 10% annually with the following breakdown:

Contribution to average annual return

Earnings growth: 5.0%

Change in P-E: 0.9%

Dividends: 4.5%

Source: "Waiting for Average," by Ed Easterling, 2005. This information and other valuable insights into stock market returns can be found at www.crestmontresearch.com.



The 1982-2000 Bull Market was anything but average

With our understanding of the three return components have contributed to stock market returns historically, let's see what drove returns in the bull market of the '80s and '90s:

Total annualized return of S&P 500 1981-1999 = **18.2%**

Where the 18.2% annual return came from:

Ave. annual earnings growth: 6.6%

Return from dividends: 3.5%

Subtotal 10.1% of the 18.2% total return

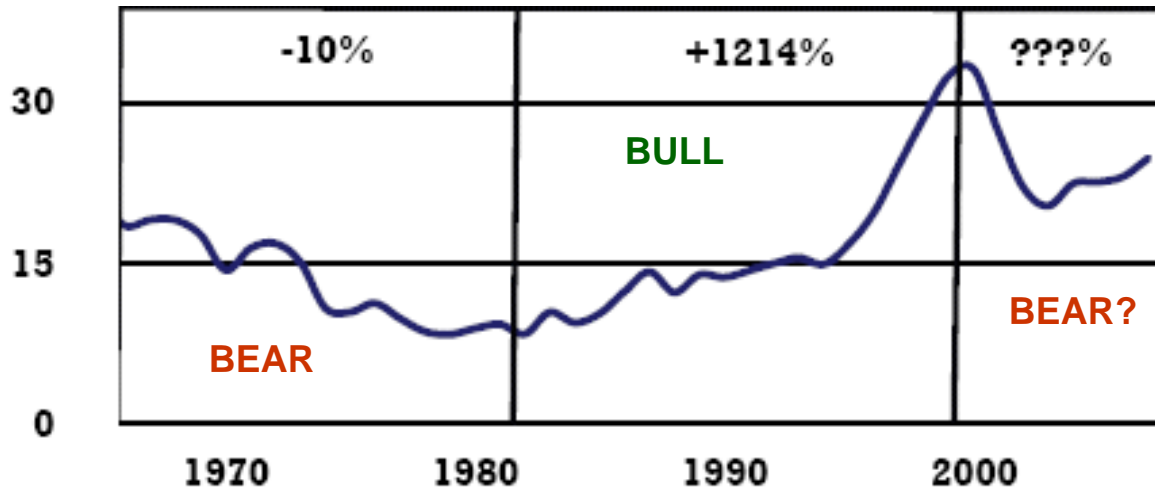
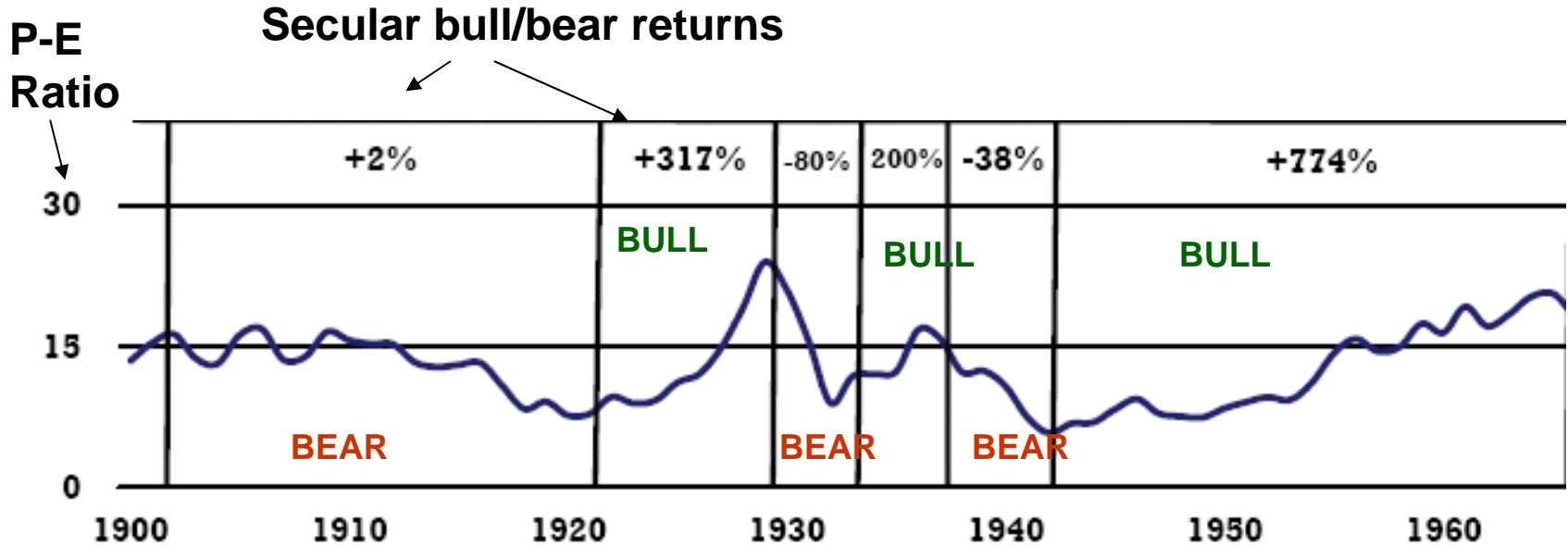
Leaves: **Return from rising P-E: About 8% a year!**

It may surprise investors that during the great bull market, earnings grew at about average rates. Dividends accounted for a 3.5% return over the period. Notice, however, that the bulk of the huge returns from the bull market came from an expanding price-earnings ratio. In other words, because investors were willing to pay higher prices for stocks, stock prices move much higher!

As it turns out, a rising P-E ratio is what makes a bull market.



In fact, that's how secular bull markets work. Rising PEs drive above average returns.



Source: [Crestmont Research](#). (PEs charted through 2007)



But bull markets are only part of the stock market cycle...

The following is a conventional view of stock market returns:

- Stocks always go up
- In fact, stocks return about 10% a year
- Even if stocks don't go up today, they go up "over the long term"
- My personal time horizon happens to coincide with that particular "long term" period

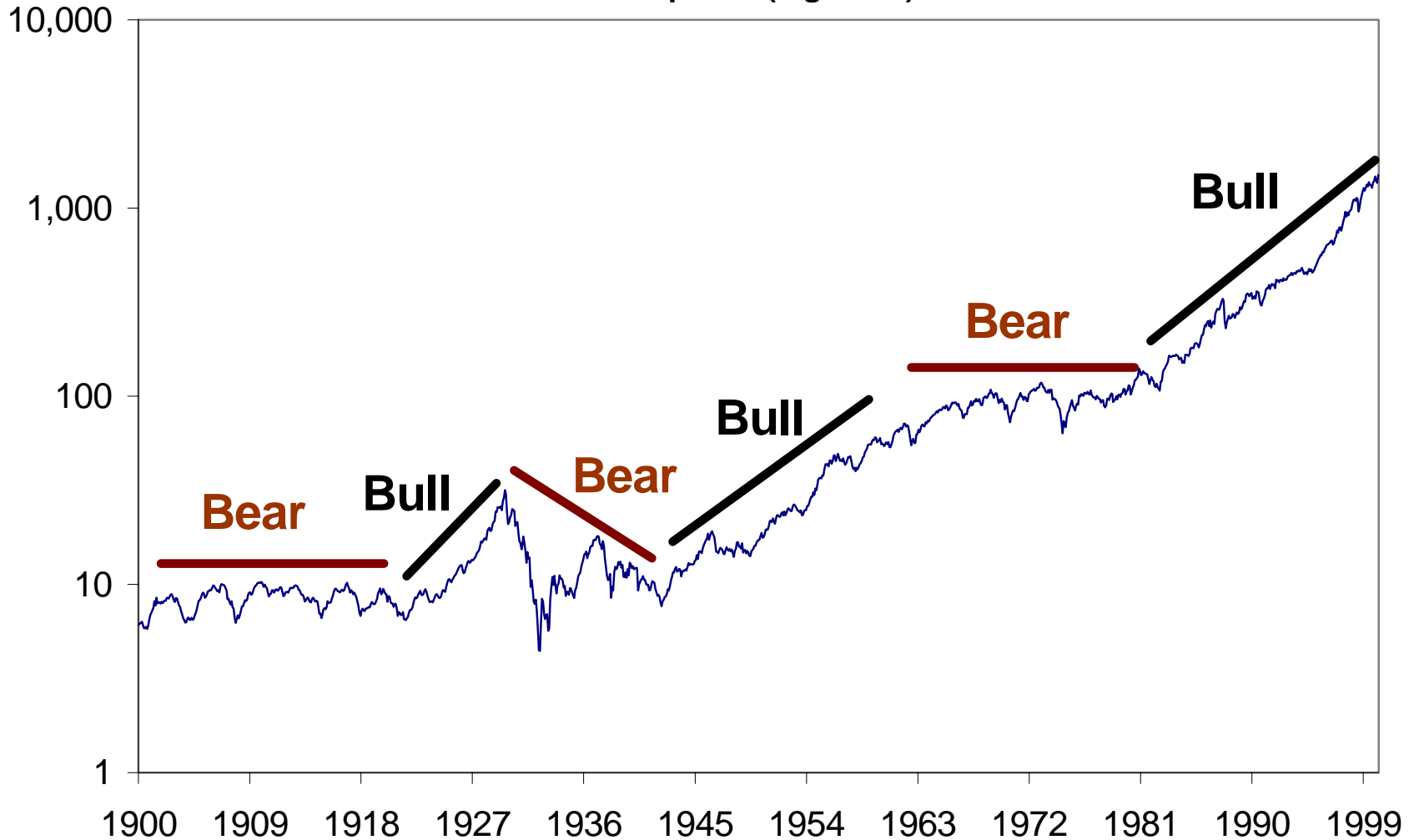
But there are long periods when stocks provide poor returns.

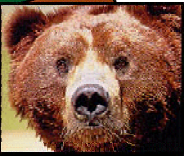


Both bull and bear markets can last for years...

100 Years of Stock Market History

S&P Composite (log scale)





And... the stock market's impressive long term returns are due to great returns from the *secular bull markets*.

Annual price change for 1900 - 1999 5.6%

Compound annual price change from
Secular Bull periods only (last century) 13.8%

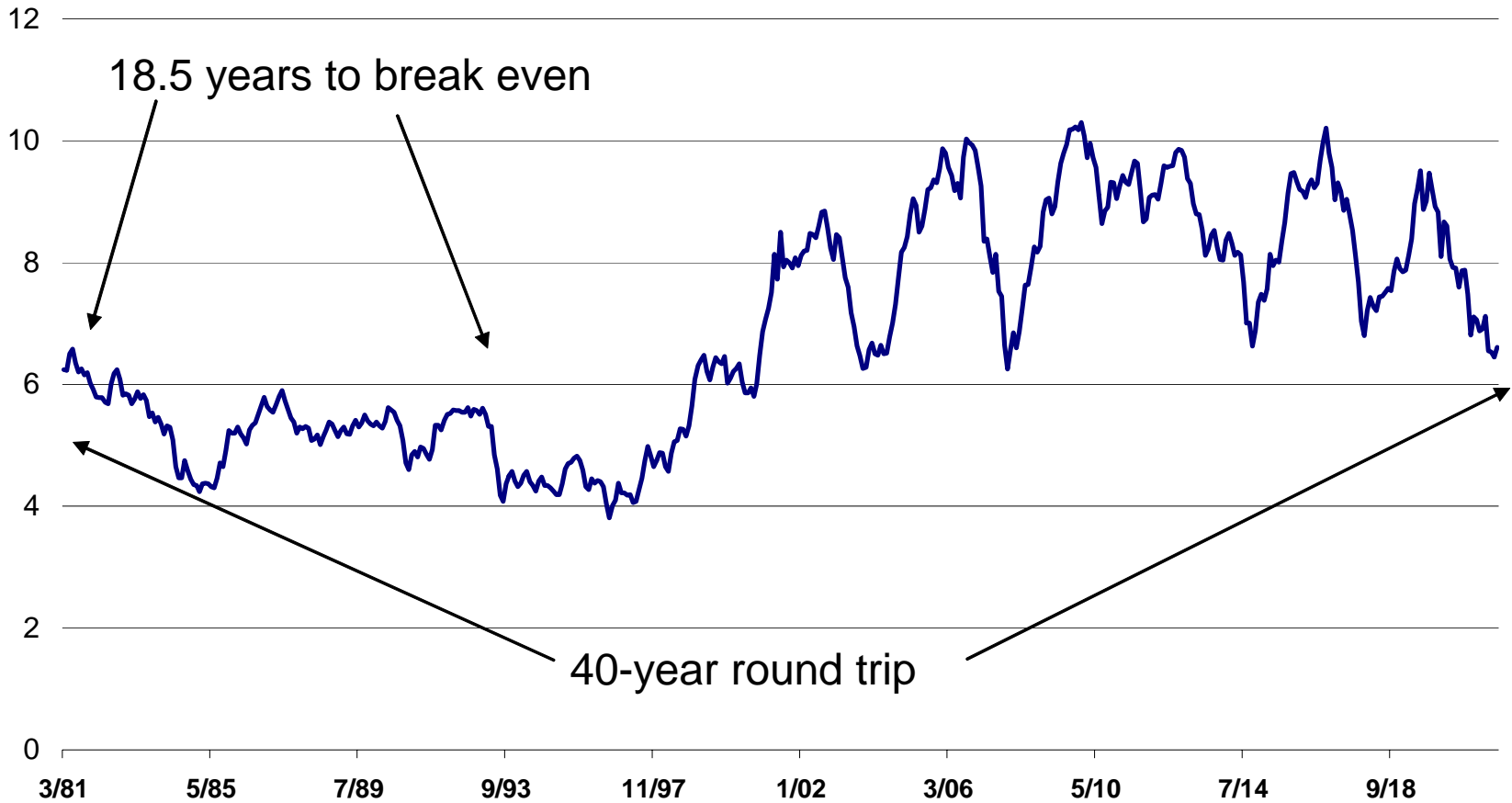
Compound annual price change, *no Secular* -1.1%
Bulls

(Simple ave. +2.1%)



Long bear markets can outlast many investors

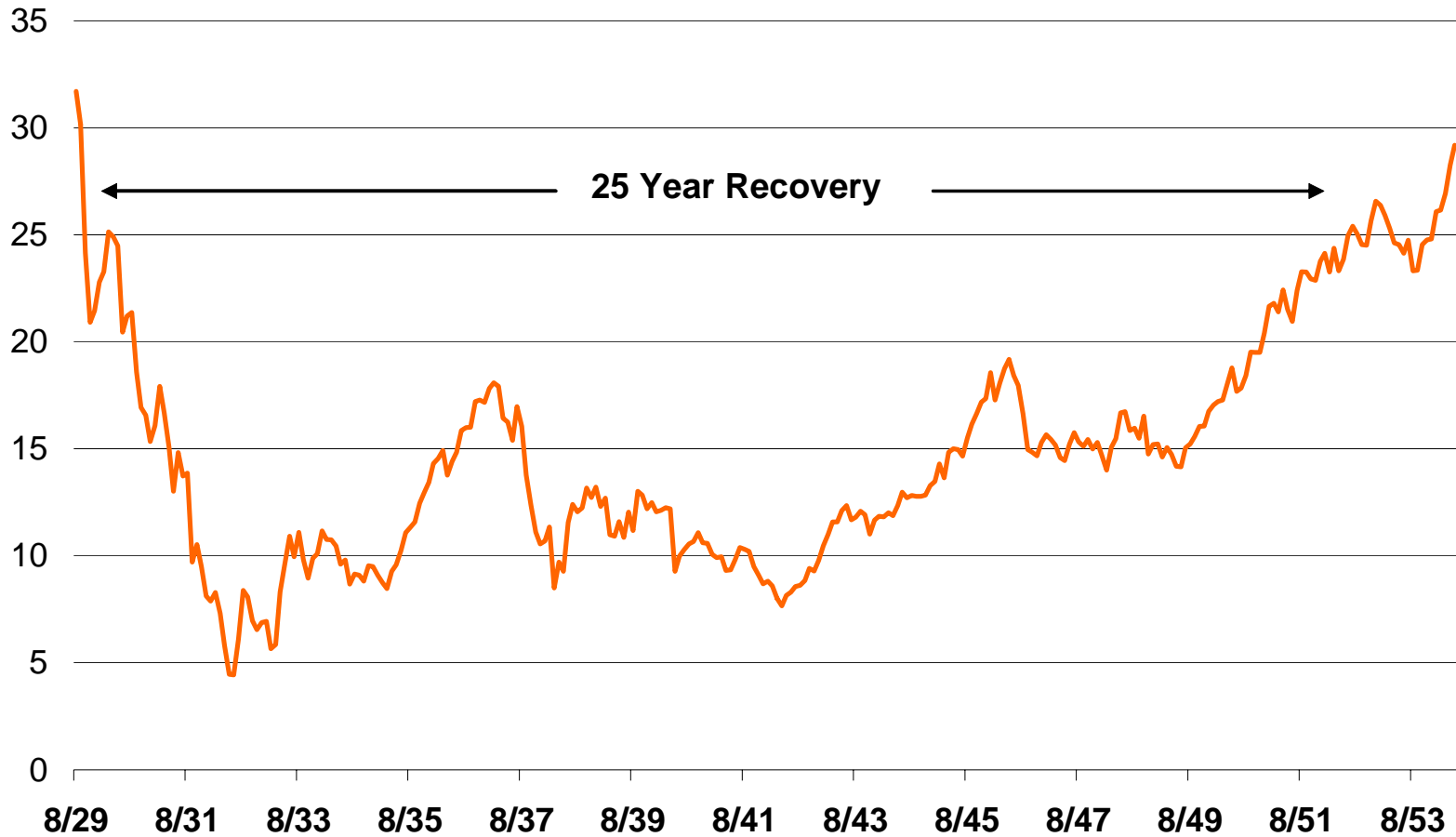
S&P Composite 1881-1921





Long bear markets can outlast many investors

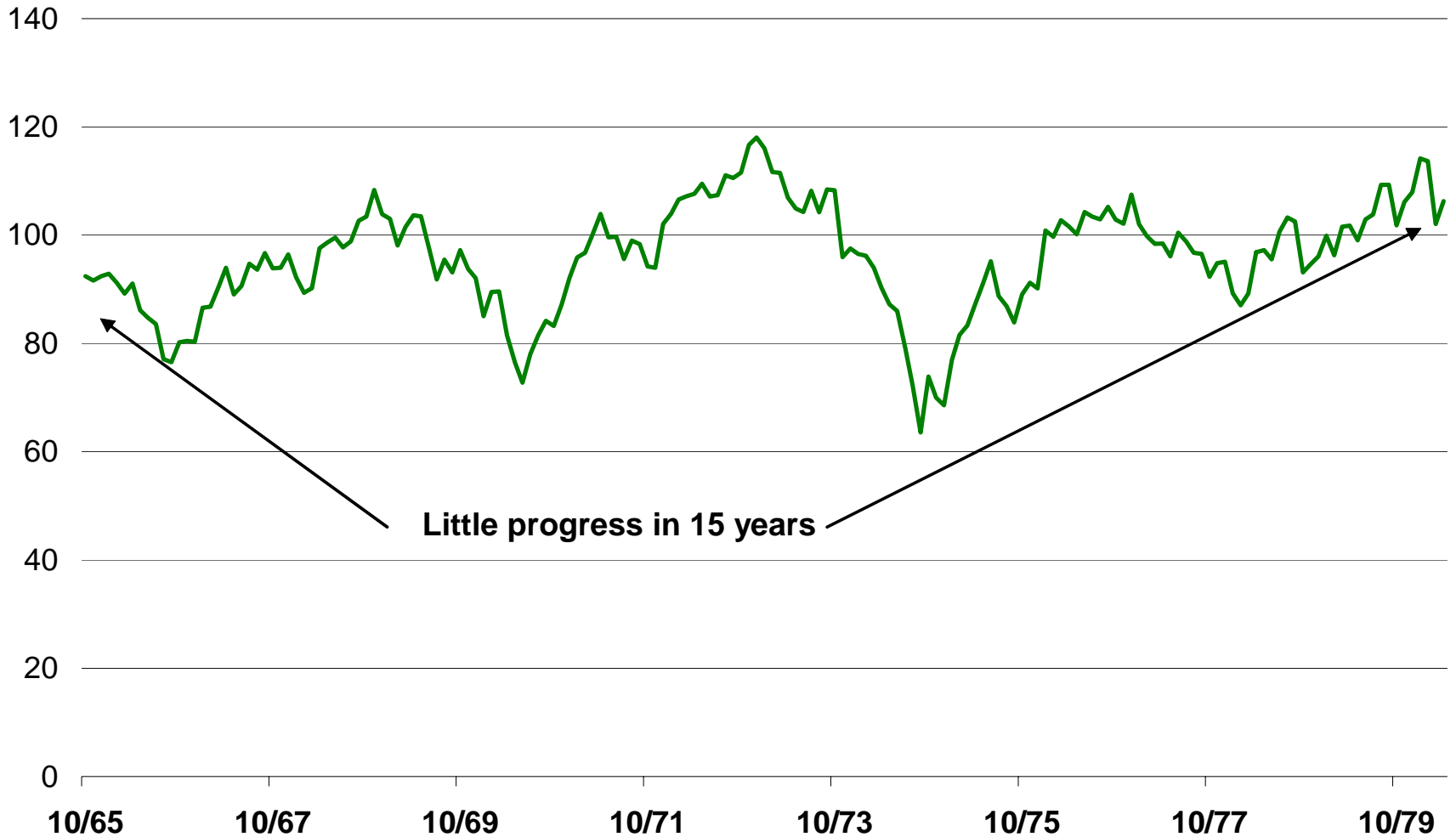
S&P Composite from 1929-1954





Long bear markets can outlast many investors

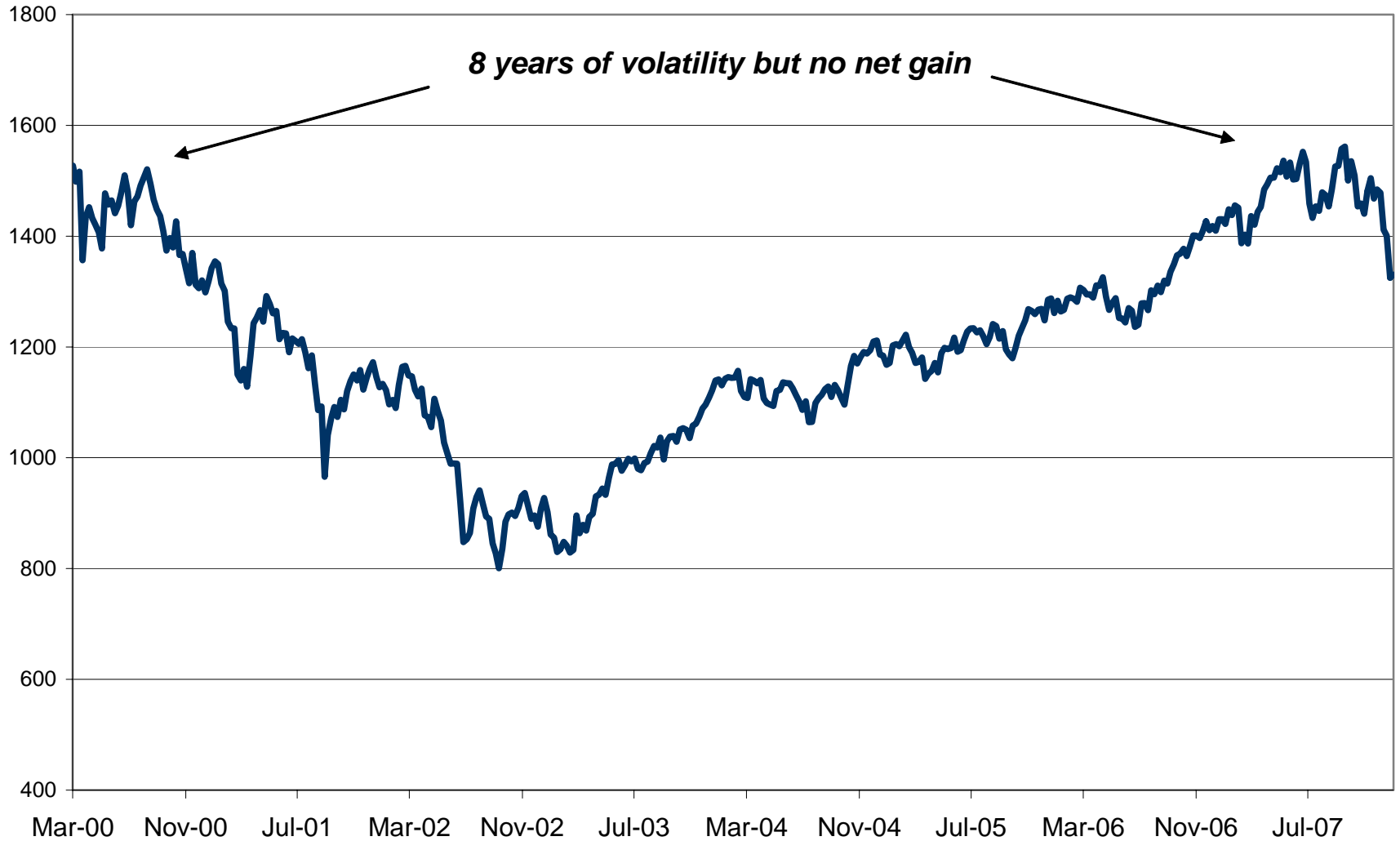
S&P Composite 1965-1980

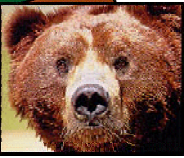




How much longer will this go on?

S&P 500 Mar. 2000 - Dec. 2007



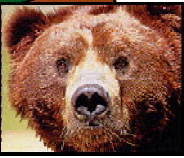


Secular bear markets can mean poor returns for years

From the end of 1929 through the end of 1936, stocks delivered an average annual *total* return of just 2.3%. Afterwards, average annual returns for the periods **beginning in 1929** and **ending in 1937, 1938, 1939, 1940, 1941** and **1942** were *zero or negative*.

Although the total return from the end of 1965 thru the end of 1981 was positive at 5.9% annually, *inflation came in at 6.7%* a year over the same period.

What triggers a secular bear market?



Secular bear markets follow secular bull markets

The bull market ran from 1982-2000. Did a secular bear begin in 2000?

Bull markets typically end at speculative peaks

The Nasdaq bubble burst in 2000

Secular bear markets usually don't end until stock market valuations are very cheap

Stocks are not yet cheap based on normalized earnings measures. (Earnings grew unusually fast in recent years and profit margins reached record levels.)

Bull markets rely on rising P-Es

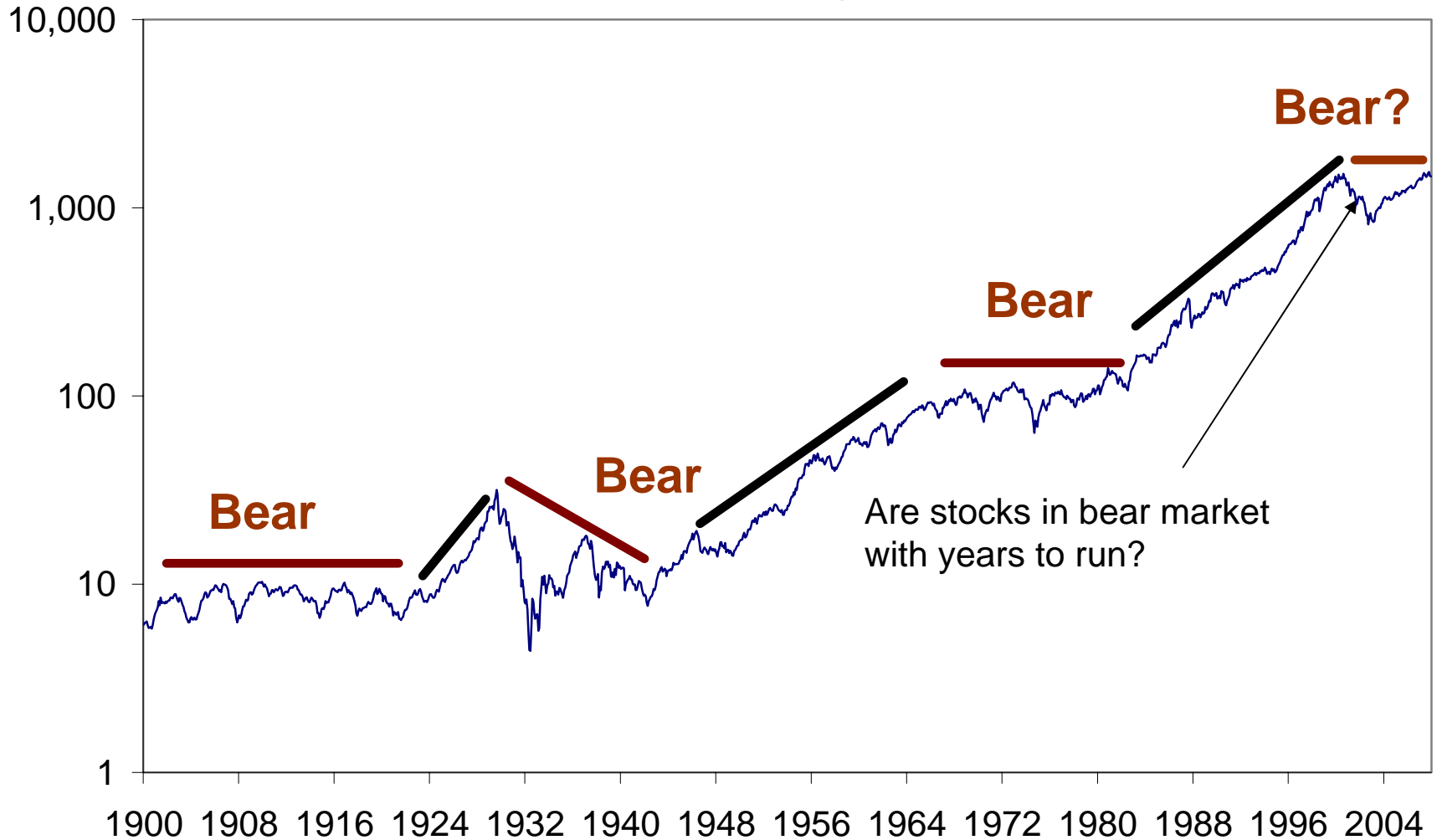
Can P-Es rise from here?



Previous secular bear markets have lasted for years

100+ Years of Stock Market History

S&P Composite (log scale)





But aren't stocks cheap when today's price is compared to forward earnings?

“Rather, the argument is about the long-term valuation of stocks. If an investor is going to use the current level of earnings to determine the reasonable price to pay for a long-term asset, it had better be true that those earnings represent a normal and sustainable level of profit. You wouldn't buy a lemonade stand by extrapolating the profits it earns in August.”

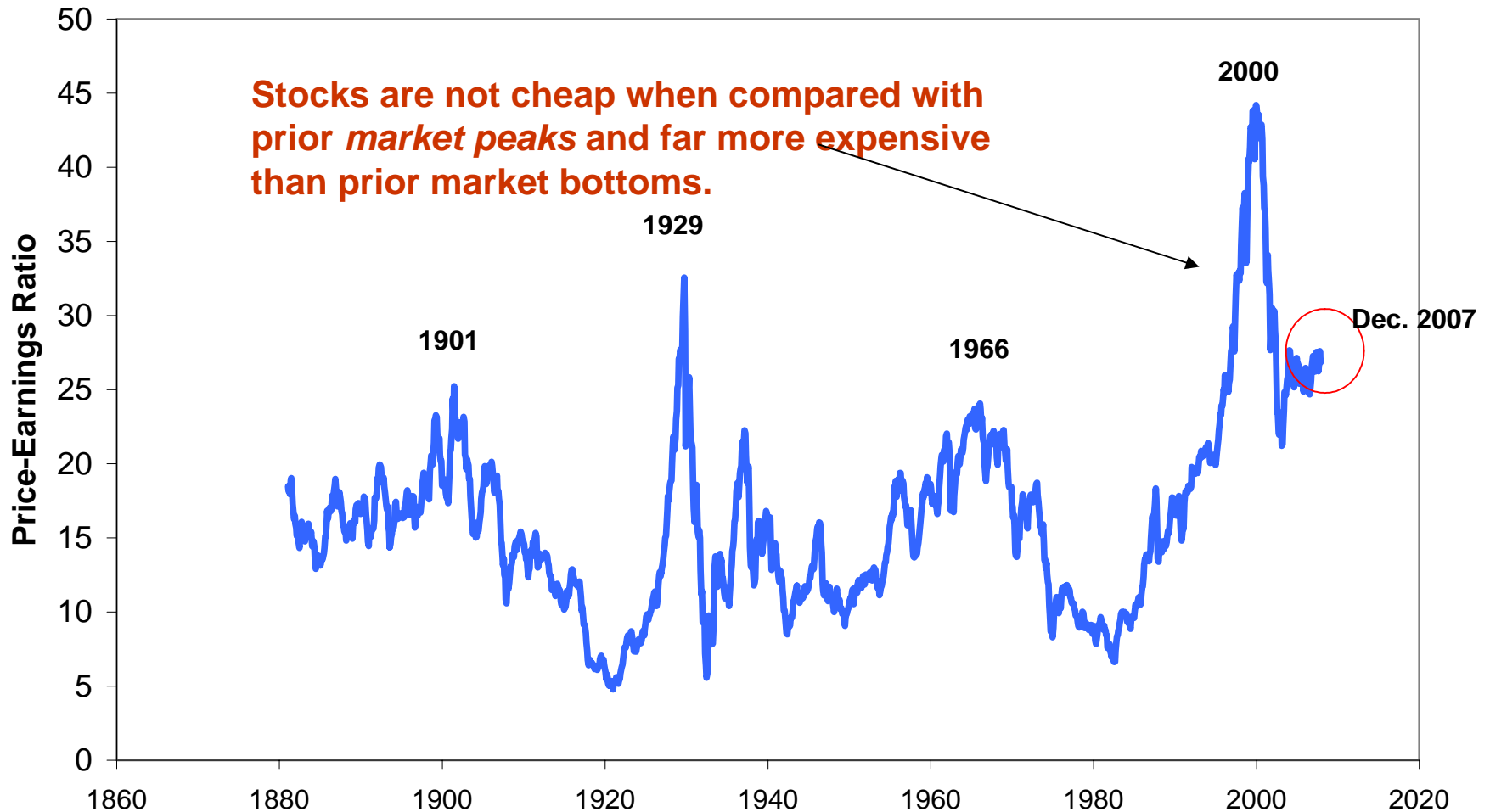
- Fund manager John Hussman, Weekly Market Commentary, Aug. 20, 2007.

Given that profit margins reached record highs in 2007, are recent earnings sustainable?



Are stocks priced as if the bear market is over?

S&P 500 Smoothed Price-Earnings Ratio
Price to Trailing 10-year moving average earnings





“But I’m interested in long term returns.”



Buying stocks at expensive valuations has historically resulted in sub-par returns – even over long periods. The table below groups 20-year periods by valuation at the time of purchase. Decile 1 = periods beginning with most expensive valuations.

S&P 500 20-Year Periods Ending 1919-2007 (89 Periods)					
Decile	Net Total Returns By Decile Range		Decile Ave. Return	Ave. PE:	
	From	To		Beg.	End
1	1.2%	4.5%	3.2%	19	9
2	4.5%	5.2%	4.9%	18	9
3	5.2%	5.4%	5.3%	12	12
4	5.4%	6.0%	5.6%	13	12
5	6.2%	7.9%	7.0%	15	15
6	8.0%	9.0%	8.7%	16	19
7	9.0%	9.6%	9.3%	15	19
8	9.7%	11.0%	10.4%	11	20
9	11.5%	11.9%	11.7%	12	22
10	12.1%	15.0%	13.4%	10	29

High starting P-Es historically resulted in sub-par returns

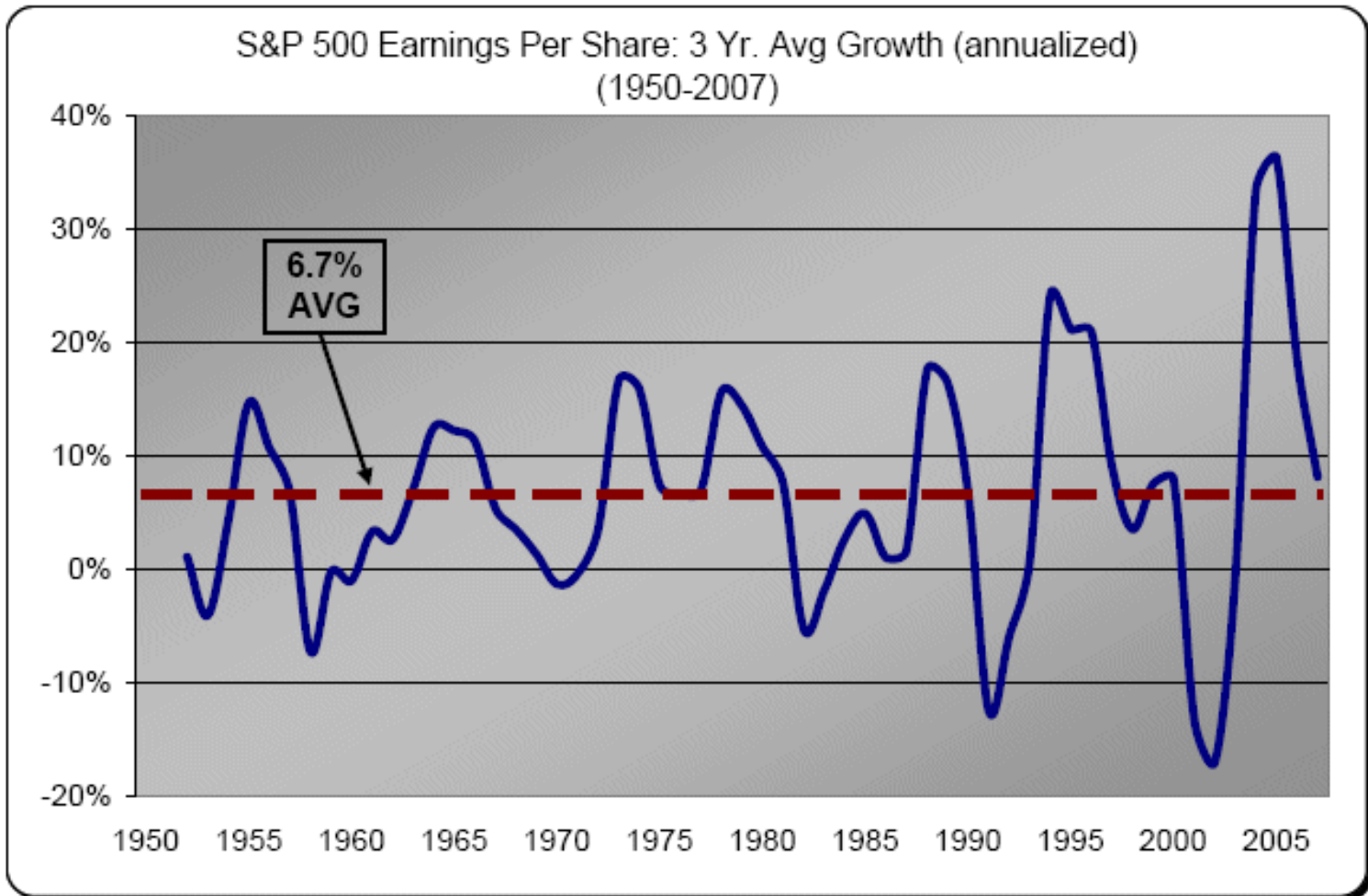
Nowhere to go but down when starting at high valuations.

For a deeper look into stock market returns and P-E ratios, visit [Crestmont Research](#) and see [Secular Markets Explained](#).



Can earnings growth make up for today's valuation?

Actually, earnings have been growing much faster than the norm.
How long can this continue?





Retiring into a secular bull or bear markets

What's left of your next egg depends on when you start:

If you retired with \$1 million with a 75% equity allocation and a 5% withdrawal rate, the value of the retirement portfolio after 20 years would be:

\$ -180,727 if you retired in **1966 (the beginning of a secular bear market)**

\$ -69,349 if you retired in **1972 (further into a secular bear market)**

\$3,575,760 if you retired in **1982 (at the beginning of a secular bull market)**

Assumes 20-year retirement, \$1,000,000 starting portfolio, \$50,000 take-out a year adjusted for inflation, and 75/25 stock/bond asset allocation.

Source: [FireCalc](#)



Secular bear market update:

Cumulative returns from March 31, 2000 through January 31, 2008, (price only):

S&P 500	-8.01%
NASDAQ	-47.74%
Gold	231%
Oil	241%

How much further to go? Bear markets typically reach extreme valuations on the downside. As discussed above, such levels have not been reached.