

# Investment Update



BNY MELLON  
WEALTH MANAGEMENT

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## Child's Play

Young children have a natural affinity for building blocks. I fondly recall my own — Lincoln Logs, Legos, Jenga and even simple stackable, multi-colored blocks. As a child, my favorite pastime was to stack blocks as high as possible before they would fall. Even today, computer games such as Tetris and BrickBreaker help grown-ups pass time at airport security checkpoints.

In the investment world, we find the concept of building blocks helpful. While analysts estimate future results in a number of ways, one that we favor is called the “building blocks” method. Over the years, we have repeatedly used this concept in our *Updates* to help illustrate the sources of equity returns.

## Building a Case for Equities

Prospective equity returns consist of earnings, dividends and valuation change. The first two are self-explanatory. The last factor — valuation change — is the degree to which investors attach a higher or lower multiple on future earnings. When investors are optimistic about the future, they often reflect this by a willingness to pay a higher premium for future earnings.

In a 2001 study by Ibbotson and Chen titled, “The Supply of Stock Market Returns,” the authors examined the components of the historical S&P 500

index returns from 1926 to 2000, based on the building blocks method that Ibbotson and Sinquefeld developed in 1976. While I have not seen it updated since the initial study was released, its content is still relevant today. It showed that the annualized return during that timeframe of 10.7% consisted of 3.08% from inflation, 2.08% from real earnings growth, 4.28% from dividend yield and 1.25% from multiple (P/E) expansion.

Using this framework to consider the next 10 years does not yield an expected return quite as strong as that of the longer-term history. While these building blocks should not be considered a specific forecast, Exhibit 1 depicts a more realistic scenario of an 8.5% expected return for the S&P 500.

Our scenario assumes that inflation averages between 2.5 to 3%, real earnings growth is 2% and the P/E multiple investors are willing to pay for future earnings modestly increases. The main reason that future returns may be lower than historical returns is due to the low starting dividend yields and limited scope for multiple expansion. Today's yield for the S&P 500 is only 1.8% and, while an increase is possible, it is unlikely that over the next 10 years dividends will contribute nearly as much as the 4.28% they did over the long history of the Ibbotson and Chen study. While a wide range of actual outcomes for equity returns are possible, we think a great many factors would need to go right for more optimistic scenarios to transpire.

This does not mean that returns for each year of the next decade will be below average. Despite the improvement in equity markets from the lows in early 2009, investors have been unwilling to place a premium multiple on 2011 earnings. Using earnings for 2011 of \$95 and the current S&P 500 level, a “forward” P/E of about 13.5 is indicated. As investors become more confident in the idea of a sustainable economic recovery with contained inflation, and as they begin to think ahead into 2012, we believe they may be willing to re-rate the equity P/E higher as the year progresses.

**Exhibit 1:**  
**Possible Scenarios 2011-2020**  
Equity Projections

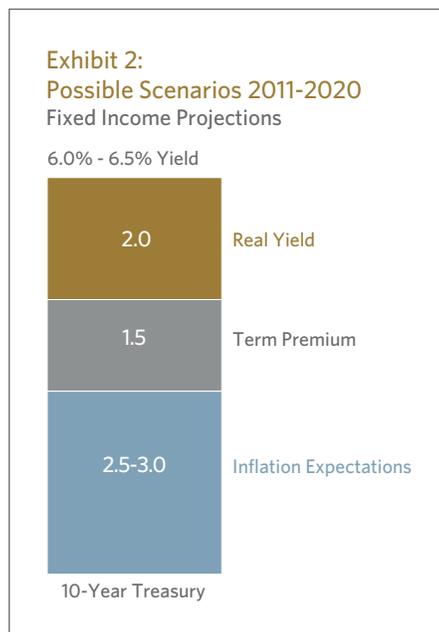


Large Cap Equities

While, in the very near-term, sentiment measures have risen enough to indicate that a pause or correction could occur, improving fundamentals ultimately may make 2011 an above-average year for equity gains. Improved economic prospects, continued strong profit growth and improving policy direction provide supportive underpinnings for equities.

### Building Blocks for Treasury Yields

A similar building block methodology, using different factors, can be applied to analyze current and prospective fixed income yields. Today, the nominal (actual) yield on the 10-year Treasury is 3.4%. The three main components of this yield are expected inflation, term premium and the real yield component. Term premium can best be defined as the extra compensation that investors demand for holding longer maturity bonds, given an uncertainty around inflation. Real yield is the residual left from subtracting expected inflation and the term premium from nominal yields. It reflects the expected future path of real short-term rates and is closely tied to the expected pace of economic growth. Exhibit 2 shows these building blocks for the current yield of the 10-year Treasury bond.



The message from our projections for these variables over the next decade is more cautionary than for that of the equity variables. We feel that there is room for each variable to rise, which could contribute to higher rates over the next few years and the decade. Real yields are likely to climb as the economy continues to improve. The term premium should rise back to its long-term average of 1.4% as “flight-to-safety” flows diminish. While currently appropriate, the embedded expectations for inflation also may increase with higher economic growth and ongoing policy stimulus. Taken together, these inputs suggest that the long bull market is transitioning into a new phase.

While the yield on the 10-year Treasury at the end of the period will depend upon economic conditions at that time, we think that at some point in the next ten years, yields could rise into the 6% range, which would reduce principal

value. Although we recommend that investors continue to hold fixed income to generate current yield and reduce portfolio volatility, they must exercise increased vigilance and use different tactics than what had been successful in recent times.

While we do not expect rates to rise dramatically during 2011, ongoing reverberations from the European markets, apprehensions over state budget obligations, increasing concerns about inflation and the diminished confidence foreign holders have in U.S. monetary and fiscal policy are reminders that now is not the time for complacency regarding a portfolio’s fixed income holdings. Discipline, active monitoring and risk controls likely will prove increasingly important.

Our expectation of relatively modest long-term returns in the coming years, presenting sometimes better prospects and sometimes worse, is consistent with the outlook that we outlined in our whitepaper, *2020 Vision: The Most Critical Decade*. Consequently, we believe that investors can benefit from being more active in their asset allocations and by considering both the longer term outlook and shorter term prospects within their strategic framework.

Christopher Sheldon  
Director of Investment Strategy