



Weekly Market Commentary



May 17, 2010

The Long-Term Outlook

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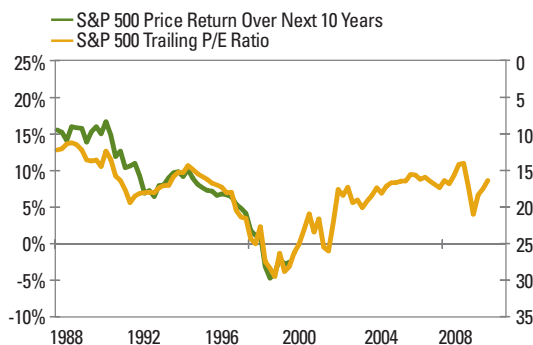
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Highlights

- We believe that the most consistently accurate predictor of long-term stock market returns is the S&P 500 price-to-earnings ratio (P/E). The P/E has demonstrated consistent success predicting long-term returns going all the way back to the 1920s.
- Focusing on the short-term can be paralyzing for many investors. Long-term investors can take heart since the P/E predicts that single-digit gains, on average per year, are likely for the stock market over the next 10 years.
- History shows us that what really matters is the price we pay, not so much what happens along the way.

1 20 Year History: P/E Predicts Gains for Stocks

S&P 500 Price-to-Earnings Ratio and Next 10 Years Annualized Price Return



Source: LPL Financial, Thomson Financial, Bloomberg 5/14/10

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Over the past year, the stock market has tended to rise most of the time on Mondays and fall most of the time of Fridays with little change, on average, on the days in between. Last week provided an exaggerated version of that pattern with a greater than 4% gain on Monday, followed by a generally sideways move during the middle of the week and a 2% sell-off on Friday. Despite a solid gain for the week as a whole that put an end to a two week pullback, the sharp moves during the week left many investors feeling apprehensive about the prospects for stocks.

Focusing on the short-term can be paralyzing. Despite the overall rise in the stock market over the past year, individual investors have generally avoided stocks. One way this can be seen is in the very modest inflows to mutual funds that invest in stocks relative to those that focus on bonds. We often take the view that volatility can offer an opportunity to be tactical when investing by taking advantage of temporary mispricing in the markets. However, those who avoid making tactical changes in their portfolios and hold a long-term, strategic perspective are often worried when volatility picks up. These investors can take heart. We believe the next 10 years may be better for stock market investors than the losses suffered during the last decade.

We believe that history has made it clear that the most consistently accurate predictor of long-term stock market returns is the S&P 500 price-to-earnings ratio (P/E). The P/E is obtained by taking the price level of the index and dividing it by the earnings per share over the past four quarters. Essentially, the P/E is how many dollars investors are currently willing to pay per dollar of earnings. It makes sense that the price you pay when you buy a stock can have a big impact on your return. The levels of the P/E and the annualized return on stocks over the next 10 years have a very close relationship, as you can see in the chart [Chart 1]. The higher the P/E, the lower the return over the next 10 years, although past performance is no guarantee of future results. Currently, this relationship predicts that single-digit gains are likely, on average per year, for the stock market over the next 10 years.

The P/E has a nearly perfect track record of forecasting long-term performance over the past 20 years or so. Based on P/E, investors should have felt confident of long-term gains and have been putting money to work in the stock market over the past year. However, many stayed on the sidelines and believe that it is different this time given the troubled banks, European credit problems, geopolitical tensions, risk of rising inflation, U.S. budget deficit, and rising tax rates among other concerns. We do not dismiss these issues. However, the P/E has demonstrated consistent success predicting long-term returns over the entire history of the S&P 500 index—going all the way back to the 1920s! [Chart 2]

