

**Investment Opportunities in the Stock Market**

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Everyone knows someone who has made a killing by buying and holding a great growth stock such as Microsoft or Berkshire -- not to mention Wal-Mart, IBM, Google, Xerox, or Intel. And needless to say, everyone wants to strike it rich in as short of time as possible!

Meanwhile, the longer road to riches is the option of buying the stock market itself (or index funds) as distinct from gambling on the next Google or investing in bonds. Thus, from 1925 to 2010, \$1 invested in each of the following possibilities would have grown to the ending amount shown below:

	<u>Nominal Value of \$1</u>	<u>Compound Annual Rate</u>
Treasury bills	\$23	3.8%
Long-term Government Bonds	91	5.5
Long-term Corporate Bonds	123	5.8
Gross Domestic Product	162	6.3
The S&P 500 Index Fund	2,979	9.9
An Index Fund comprised of Small Company Stocks	7,860	11.1

The core reason that stocks outperform both bonds and the economy, is due to the magic of compounding. Indeed, Nobel laureate Paul Samuelson once declared compound interest (or growth) to be “the eighth wonder of the world.” Moreover, according to Burton Malkiel (former Dean of the Yale School of Management and a professor of economics at Princeton), Albert Einstein went a leap further and declared compound interest to be “the greatest mathematical discovery of mankind.” (See the latest edition of Malkiel’s widely acclaimed book, *A Random Walk Down Wall Street*, for confirmation of this astounding observation.)

Meanwhile, there an extraordinary proportionality between compound rates of growth (interest or return) and time that the following examples make clear:

- For any compound annual rate of return, when the number of years an investment of \$1.00 is held is DOUBLED, the ending value of that investment is SQUARED. For example, at a 10% annual return an investment of \$1.00 becomes \$6.73 in 20 years, \$45.26 in 40 years and \$2,048.40 in 80 years.
- For a given number of years, if the compound annual rate of return is DOUBLED, the ending value of a \$1.00 investment is approximately SQUARED. Thus, \$1.00 compounded at a 5% rate for 40 years becomes \$7.04 and at a 10% rate for 40 years grows to \$45.26.

These relationships go a long way toward explaining the “magic” of compound interest while the core difference between stocks (with high returns) and bonds (with low

returns) is compounding. In the case of stocks this is due to the reinvestment of retained earnings by the company and reinvested dividends to buy more stock by the shareholder which results in the reinvestment of 100% of annual profits. This, in turn, can lead to a compounding chain reaction!

Then there is the critical effect of **leverage** that works in favor of common stocks. Thus, the average debt to equity ratio for companies in the S&P 500 is two to one. Not only is the firm's own capital hard at work for investors but additional capital (borrowed at a lower rate of interest than the firm's ROE) serves to multiply earnings as well.

So how does one take advantage of all this? Well, here are some common stock decision rules (or selection criteria) that have worked for extended periods in the past:

- Low Price/Earnings ratio
- Low Price/Book Value ratio
- Low Price/Sales ratio
- Low Value Index i.e.,  $(\text{Long Term Estimated EPS growth Rate} + \text{Yield}) / \text{PE}$

#### **Principles of Model Construction**

- Use models combining two or more of the above selection criteria.
- Use quarterly re-balancing instead of annual rebalancing.
- Moderate the selection universe by excluding utilities and financials.
- Hold small portfolios comprised of only 10 to 30 stocks.

For an explanation of the conceptual underpinnings of the above value related strategies see *High Growth vs. Cyclical Stocks – Some Important Differences in the Factors Affecting Price Performance*, on the paradoxinvestments.com Website.

Meanwhile, here are a few facts about the stock market worth noting: The historic (long-term) advantage of investing in common stocks versus corporate or government bonds is dramatic. For example, over the 85 year period spanning 1925-2010, there have been 61 non-identical 25 year holding periods when one could have invested in either common stocks or corporate bonds. Note, however, that over this entire time span there has been only one 25 year period in which stocks did not outperform bonds. Thus, the best 25 year total return for stocks was 5,238% versus 1,336% for bonds. Likewise, the worst 25 year return for stocks was actually a gain of 319% compared to a 45% gain for bonds. Needless to say, these results speak volumes about the impact of reinvested earnings (compounded) on the long-term advantage of investing in common stocks.

Moreover, for the 20 years, 1979-1999, the total holding period return on the S&P 500 was an extraordinary 2,581.3%! Perhaps in reaction to this, the stock market has been virtually flat since 2000 even though corporate earnings have gone up by almost 100%! On the other hand, despite the market's stellar long-term performance (such as an inflation adjusted holding period return of a stunning 1,091% for the 18 years 1982–2000) the market limped in with a dismal holding period return of -38% for the 9 years 1965–