

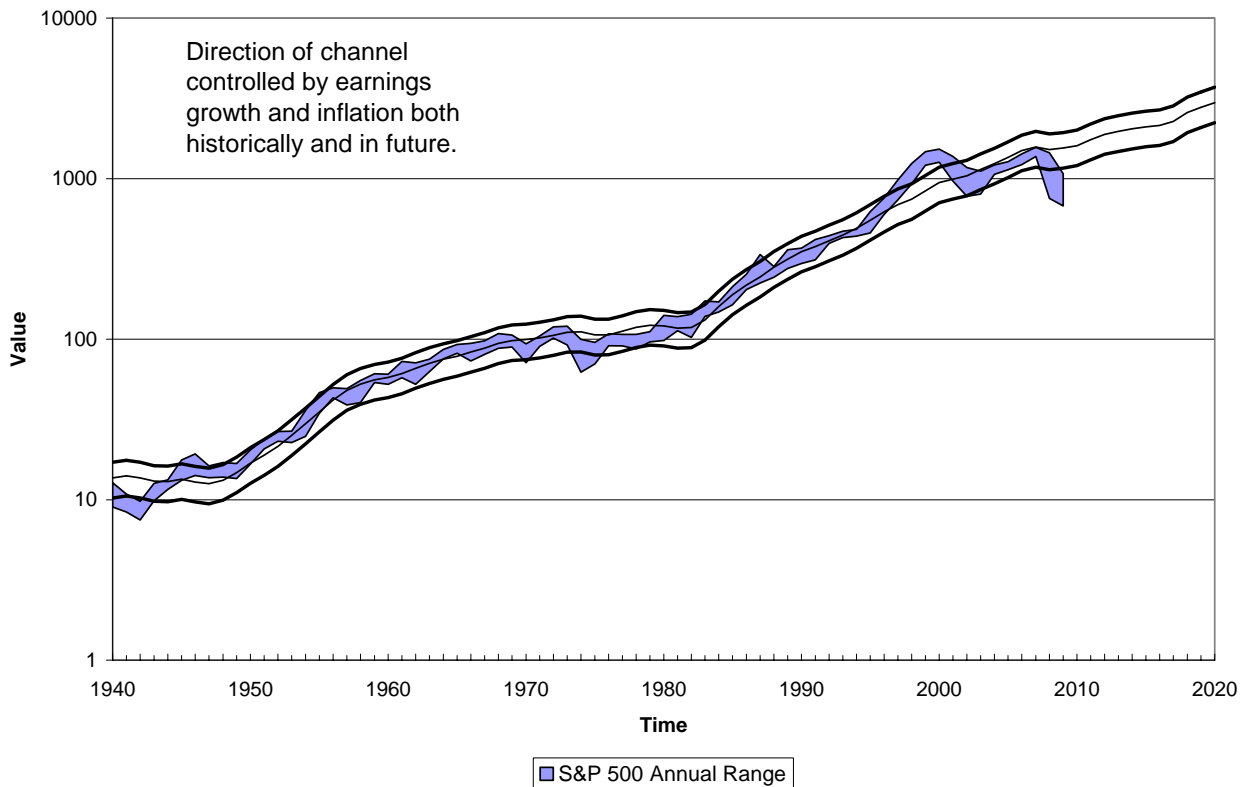
## ***“There Are No New Paradigms In Investing!”***

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### **What Is Fair Value**

Eads & Heald Investment Counsel’s proprietary “Fair Value Channel” (below), shows the market, as measured by the S&P 500 index, as undervalued versus our estimation of “fair value”. Seemingly, that would appear to be good news, and in a sense it is good news. Valuations, despite recent run-ups, may still be attractive.

### **Fair Value Channel**



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## **Risks**

Unemployment rates, potential inflationary risks, and economic/political uncertainties remain serious threats. As long as unemployment is relatively high, and presumably rising, the economy and the stock market will suffer. People spend less and cut back when jobs and incomes are being whipsawed out from underneath. Inflation will likely be held in check by the Fed, but that remains to be seen. The market dislikes uncertainty. Debates rage over healthcare reform, Government bailouts, and other economic and political uncertainties. Again, the market dislikes uncertainty.

## **Suggestions For Cash**

Lumped together, these indicators cause Eads & Heald Investment Counsel to offer the following generic guidance for investors with cash on the sidelines. Obviously, one size does not fit all. An investor's age, time-horizon, risk tolerance, overall financial health, and other factors must be considered before applying any investment guidance to your specific situation. For example, older investors with a low tolerance for risk and a short time horizon may want to have excess cash and/or fixed income securities, and less equity exposure.

With the aforementioned disclosure out of the way, Eads & Heald Investment Counsel views the current state of the economy as a situation where putting cash to work in the equity markets might make sense. Specifically, one might undertake a plan wherein a modified form of dollar-cost-averaging over 12-24 months, or so, might be appropriate for certain investors with long-term time horizons (Eads & Heald Investment Counsel defines "long-term time horizon" in this case as 10+ years).

## **Discourse on Paradigms**

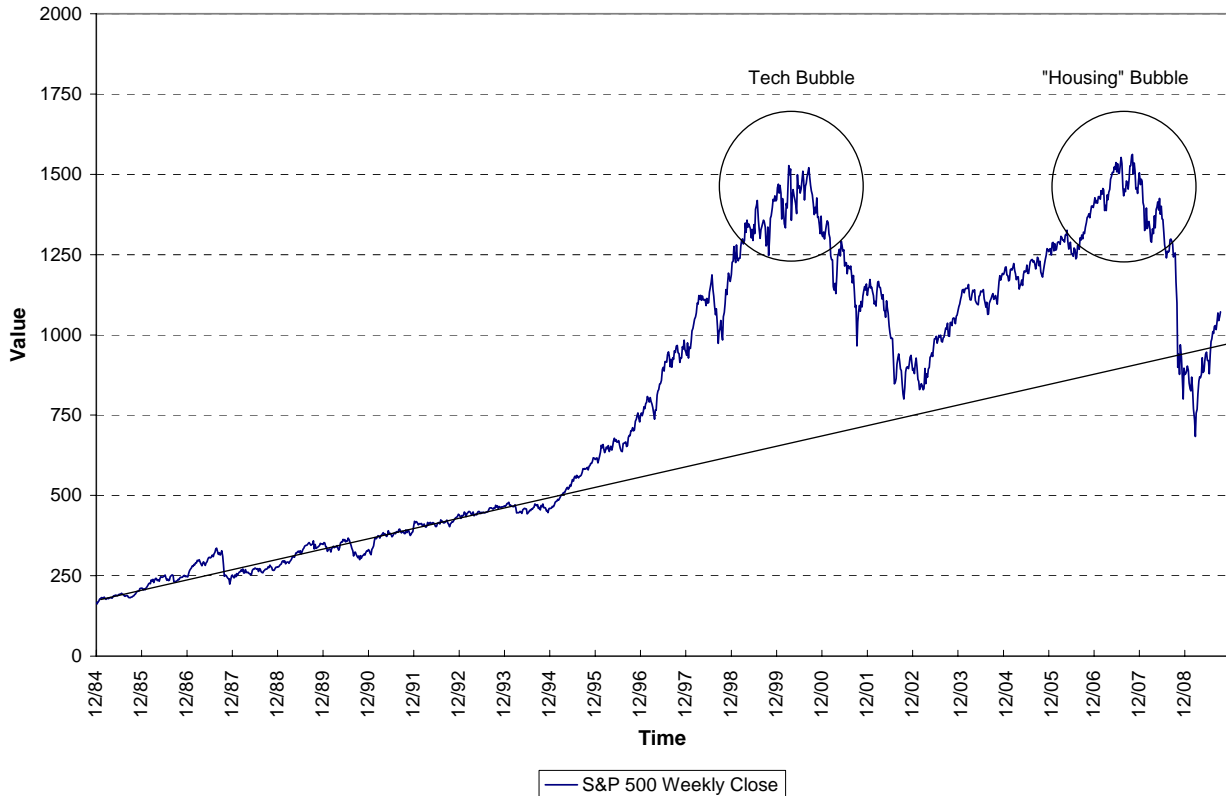
There is much talk about the stock market being in a "new paradigm", where stocks are too risky. Where have you heard the phrase "new paradigm" before? The technology bubble was a "new paradigm", if one is to believe the media at the time. Technology stocks were the new normal. Seemingly, nothing could stop technology stocks, and their enormous PE ratios were here to stay.

The chart, "S&P 500 Weekly Close" (below) puts to rest what we all now know was a myth - that the tech bubble was a "new paradigm". Look at the drop-off. Obviously, there was no new paradigm, just as there is no new paradigm now. Of course, there is a difference between the 1990's tech bubble "new paradigm" and the current "new paradigm". In the 1990's, the new paradigm was that ultra-fast-growing stocks were the new normal. In the current new paradigm, stocks are seemingly considered too dangerous and/or passé. In the current new paradigm, some suggest that "buy & hold" is out of date. Such charges are derelict.

It would be just as dangerous to buy into the current rumors of a new paradigm, as it was to buy into the rumor of a technology stock new paradigm. Buying into today's paradigm could hinder an investor's long-term wealth accumulation.

# S&P 500 Weekly Close

Through  
10/9/09



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We are in an era where the market has been beaten down more rapidly, and more severely, than any time since the oil-embargo, high-inflationary days of the early 1970's. Investors have recently experienced losses from which some may never fully recover. These facts are true and disappointing. It is easy to become a victim of market psychology and it is easy to point to the recent destruction of wealth as "evidence" that investors should avoid the equity markets. Doing the opposite of what is easy usually offers the most reward, even considering the risk taken to earn that reward!

The market will recover. Certain investors in earlier stages of their investment life-cycles may be in a unique position, despite recent run-ups, to take advantage of a buying opportunity. Therein lays the message for those who are in a position to take advantage of circumstances.

## Attributes of Equity Exposure

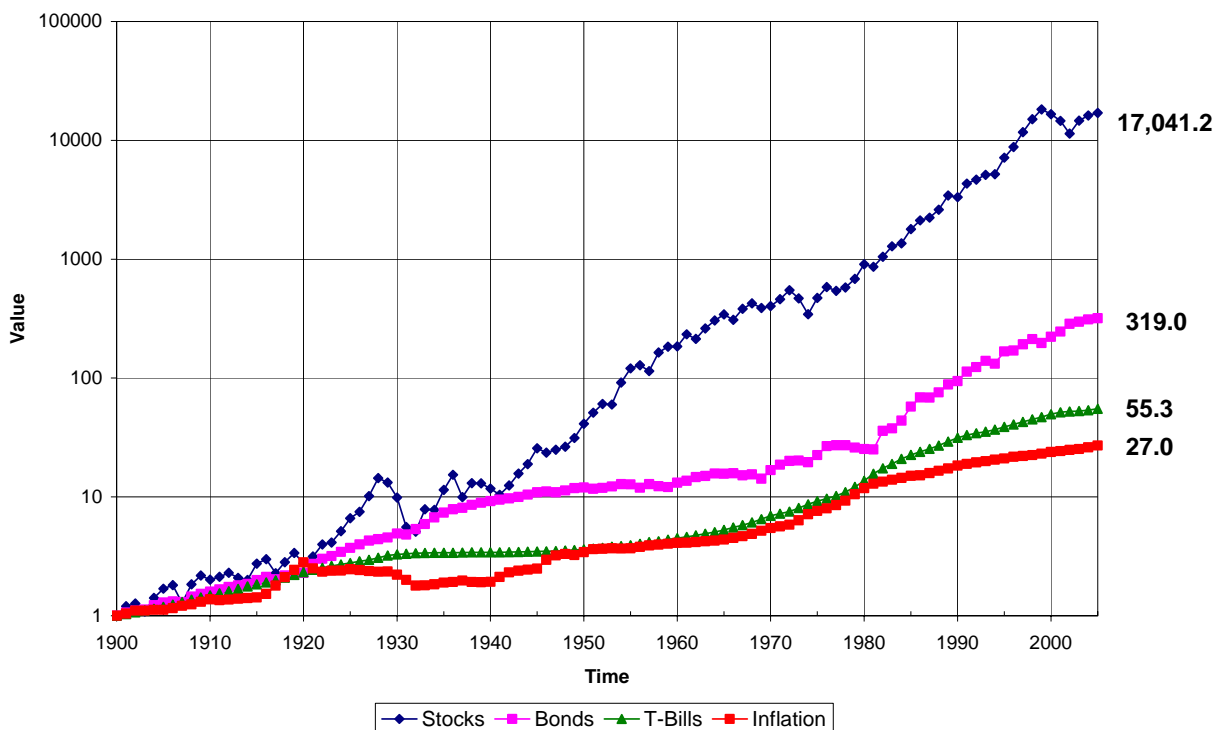
Please take a look at the chart “Growth In Wealth” (below), which shows the appreciation of stocks versus bonds, inflation, and t-bills. These are actual appreciation values, not a made up model. The picture speaks for itself. Over reasonably long investment time horizons, stocks remain the vehicle of choice to soundly beat inflation. After all, inflation is the ultimate enemy. If your assets grow at a rate less than inflation, your spending power is reduced.

Recall that stock return is made up of three parts, and only three parts. Returns are made up of growth rate in earnings, dividend yield plus or minus the change in PE. Mathematically:

$$\text{Return} = \text{Earnings Growth Rate} + \text{Dividend Yield} \pm \text{Change in PE}$$

Historically, a reasonable average earnings growth rate is about 6.5% and dividend yield is about 3.5%. This equates to a long-term average return on stocks of about 10% per year, ignoring all other factors, such as taxes.

### Growth In Wealth: Stocks, Bonds, T-Bills and Inflation

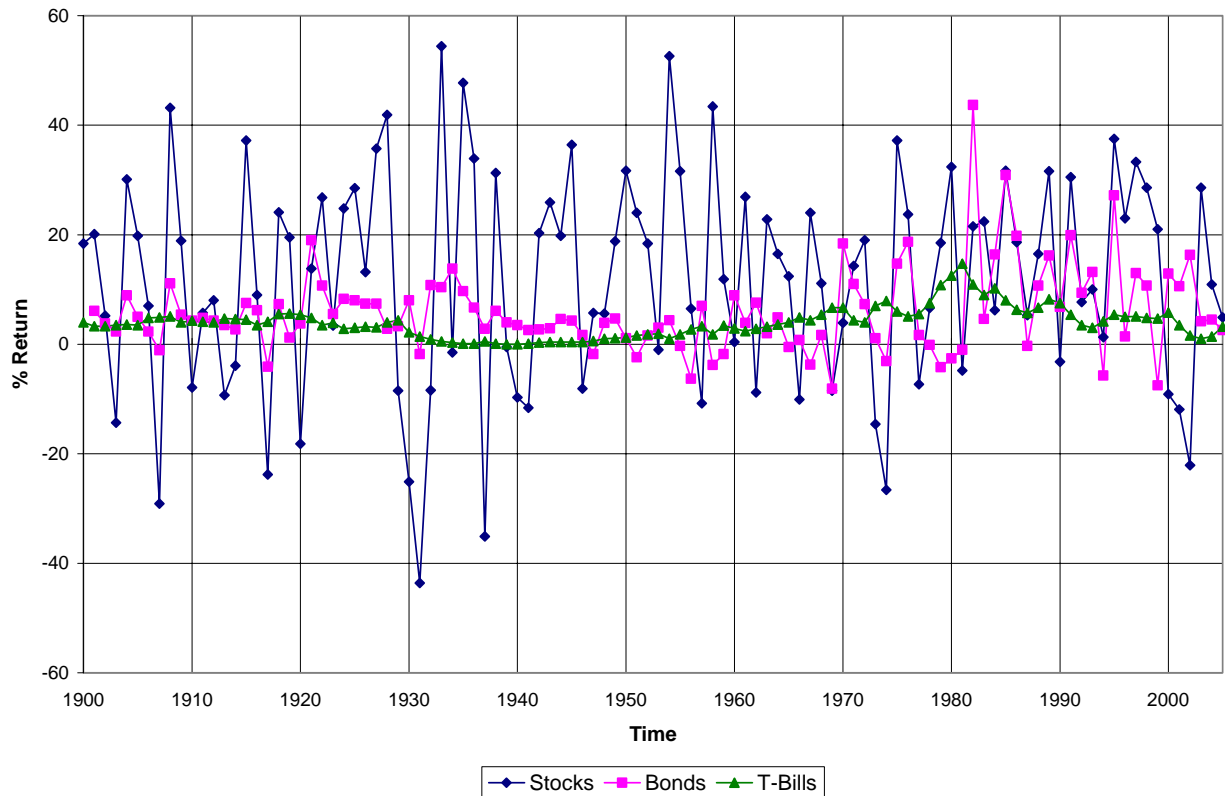


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## Risks of Equity Exposure

So, what is the trade-off? The trade-off is that there is never any return without a commensurate level of risk. Look at this chart “Annual Rates of Return” (below). This chart shows the year-to-year volatility (erratic up/down behavior) of returns from stocks, bonds, and t-bills. Stocks reflect the greatest short-term volatility (ie, risk). Interestingly, note the increased volatility of bonds in recent years, since about 1980, along with an up-trend in bond returns. Again, there is never increased return without a commensurate level of risk!

### Annual Rates of Return: Stocks, Bonds and T-Bills



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## Lessons

So, how do we put these charts together for practical application? The important lessons are as follows:

- ❖ According to Eads & Heald Investment Counsel's Fair Value Channel, stocks appear attractively valued, despite recent gains. If the success of our model in the past (via how well it captures the actual highs and lows of the S&P 500 index) is any indication of the future (and it may not be a good indicator this time around, because nobody can see into the future), then perhaps our conclusion that stocks are attractively valued is correct.
- ❖ Stocks remain the investment of choice over the long-term to out-run inflation.
- ❖ However, one must be able to swallow the year-to-year beatings one might face from stocks. One year, stocks may be way up, and the next year they may be way down. There may be several year periods, such as the late 1990's, when everyone thinks they are a stock-picking guru. Conversely, there may be several year periods, such as the last few years, when the world seems to be coming to an end and pundits begin stating that stocks are too risky and/or we are in a "new paradigm".
- ❖ Historical facts show what they have always shown – that is, stocks are the best long-term vehicle for capital appreciation, especially against the enemy of inflation, but hold notable short-term risk.
- ❖ Investors with the foresight to accept the short-term fluctuations in stocks, in return for longer-term performance (which averages the good with the bad), will likely do well.

Balancing what Eads & Heald Investment Counsel believes are attractive valuations (via our proprietary Fair Value Channel) with notable market risks (unemployment, inflation, economic/political climate), we come to the conclusion that investors with cash on the sidelines might do well to use a modified form dollar-cost-averaging over 12-24 months in order to gain equity exposure and build long-term wealth. The environment for stocks at this time might justify this strategy for those who are able to look out 10+ years, or so, or have other assets with which to cushion near-term volatility.

### In Closing...

Clearly, as stated before, an investor's age, time-horizon, risk tolerance, overall financial health, and other factors must be considered before applying any investment guidance to your specific situation. Further, the discussion of how to construct a potentially effective equity portfolio warrants another article in and of itself. Alternatively, consult a professional investment manager who holds the Chartered Financial Analyst (CFA) designation and whose fee is based on a percent of assets under management.

Feel free to contact Eads & Heald Investment Counsel if you would like to discuss this further. Eads & Heald Investment Counsel manages customized and individually managed stock and stock/bond portfolios starting at \$250,000.