LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

In grossly oversimplified terms, an investor has two choices: to own a business, or to lend to a business. As owner, he is entitled to the profits (if any) which can be taken out as dividends or retained in the business. As a lender, the loan is a promise to pay interest and to repay the loan at a specified time. The loan has first—but limited—claim on the profits and assets of the business. Theoretically, the expected return from loans (bonds) should be less than the expected return from business ownership (stocks). It does not always work that way—for a time at least.

The 1996 year-end *As We See It* (available on our website) discussed the apparent anomaly of bond yields being higher than common stock earnings yields. At that time, the memory of a painful inflation was still fresh in investors' minds. They had learned that the rising interest rates that accompanied inflation punished bond values. Stocks, on the other hand, had a very good run and were widely believed to achieve excellent returns. Twelve to eighteen percent equity returns was a widely accepted expectation. In broad terms—using the year-end numbers from the Merrill Lynch Master Corporate Bond Index and the Standard and Poor's 500 Index—bonds yielded 7.09% and stocks returned 5.2%—1.9% in the form of dividends and 3.3% in retained earnings. Much has happened since.

For a time, stocks did well. In 2000, the tech stock bubble burst, but The Federal Reserve applied the easy money cure and the market and the economy got going again. The easy money found an outlet in the housing/real estate bubble. In 2008, that bubble burst—big time. It was a monster credit crisis the likes of which had not been seen since the Great Depression in the 1930s. Stocks plummeted, and banks (large and small) failed. Lehman is gone as is Bear Stearns. Merrill Lynch, Wachovia, and Countrywide have been absorbed into other financial organizations. AIG almost went bankrupt and General Motors did. Washington stepped up with TARP, *Cash-for-Clunkers*, first-time homeowners' rebates, direct cash payments to everyone, and direct aid to states and municipalities. The federal budget deficit soared. The Federal Reserve supplied extraordinary amounts of liquidity and is currently engaged in a second big quantitative easing. Full economic recovery looks to be a long way off.

These events have changed the terms the market now offers investors. Using the same indexes as in 1996, bond yields have come down to 4.1%—a 43% decline. Stock earnings yields are now 6.7%—a rise of 28%—and are now 64% higher than bond yields. That is a significant change from 1996 when bond yields were 36% higher than earnings yields.

Two index numbers are not a sufficient basis for setting investment policy. They do, however, raise a couple of points that investors should consider.

Neither 4.1% interest rates nor 6.7% earnings yields validate the higher assumed rate of return that many individual retirement plans and pension plans are still using. Investors need to think seriously about lowering those expectations and increasing their savings.

Stocks took a terrible beating in the credit crisis in 2008. Many investors were hurt and frightened, and now shy away from stocks altogether. This may be a mistake. With earnings yields now 60% higher than bond yields, perhaps stocks need a closer look.

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