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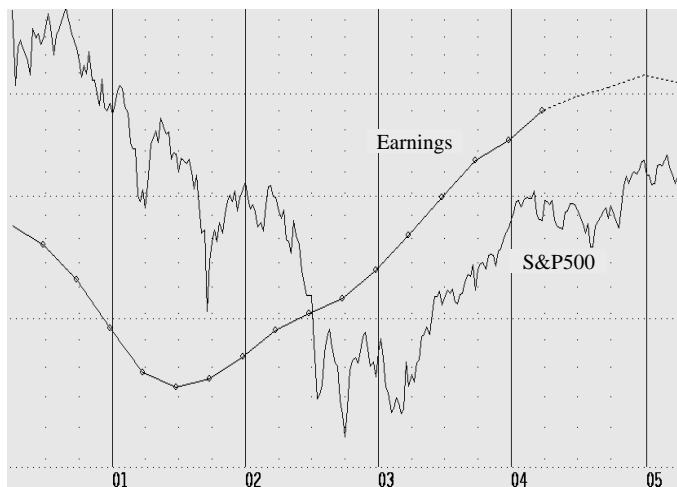
THE VIEWPOINT

Spring 2005

With financial markets fixated on oil prices and some experts believing oil might go as high as \$80 a barrel, you may be expecting another article on the price of oil and its effect on the market. That is what this newsletter was going to be about until I started to focus on the record trading volume in the commodity futures market. This record volume suggests that there is a lot of speculation in the commodities market.

This led me to think about the last time we saw so many speculators jumping on the band wagon; technology. As I pondered the run up of the stock market in the late 90's, I realized it has been 5 years almost to the day since the NASDAQ market peaked.

After it peaked in 2000 the NASDAQ fell over 70% while the S&P500 dropped more than 40%. The averages set their lows in September of 2002. Since then the NASDAQ is up 70% and the S&P500 is up 44%. One would think the markets are back to their old highs but when you lose 50% you need to gain 100% to get back where you started. (See chart below.)



Individuals who invested in the S&P500 have less money today than they did 5 years ago. The NASDAQ is down 55% and the S&P500 21%. This is one of the few five year periods in which you would have lost money investing in the S&P500. Of course this was preceded by

one of the best 5 year periods. Over the last 10 years the S&P500 is up 139% or 9% per year.

During the past 5 years we have had a barrage of bad news that could fill this page. For instance, the U.S. economy went through a recession, we had the terrorist attacks on 9/11, two wars in the Middle East, a tsunami in Asia and record energy costs. However, in every year except 2001, a recession year, the earnings for the S&P500 went up. (See chart.)

This means the price one has to pay for the earnings of the average company has steadily declined. In 2000 you had to pay 31 times earnings to buy the average company in the S&P500. Today the S&P500 trades at a P/E of 17. Obviously when the market was at 31 times earnings it was overvalued. The S&P500 had never traded that high before. The question is whether 17 times earnings is a reasonable valuation or does the market need to fall further to become fairly priced?

As discussed in previous newsletters, interest rates can be used to determine at what P/E the market should trade. Today the 10 year treasury has a yield of 4.57%. Using the Fed model, this would mean that 23 times earnings would be fair value for the market. Our proprietary PEG model comes up with similar results. With interest rates rising, the fair value for a company's earnings will go down. For example, if the 10 year treasury were to yield 5.5% our model would suggest a P/E of 21, still 23% higher than the market is today.

This quarter and the last 5 years negative performance have made it tough to hold equities. But with earnings rising during this period companies have gotten cheaper making now a good time to scour the market for good companies with rising earnings that are undervalued.

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