

# The Ambachtsheer Letter

Research and Commentary on Pension Governance, Finance and Investments

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## LOOKING ACROSS THE ABYSS: A PENSIONS ACTION AGENDA FOR 2009 AND BEYOND

Unusual times require unusual responses. In the final edition of this very unusual year, we break our single-topic rule for *The Ambachtsheer Letter*, and address three distinct, but related topics: (1) long run return prospects for stocks from today's prices, (2) risk and funding policies for 2009 and beyond, and (3) the once-in-a-lifetime windows for pension and financial system reform that are now opening. All three topics are critically important agenda items for pension organizations in 2009 and beyond. The commentaries below provide decision contexts for each.

### STOCKS FOR THE LONG RUN...AGAIN?

*"I believe in stocks for the long run .... but only if purchased at the right price".*

Bill Gross  
PIMCO Investment Outlook  
December 2008

#### The 'Ebb-and-Flow' Theory of Stock Pricing

Some years ago, we had an opportunity to debate Wharton Professor Jeremy Siegel, of 'stocks for the long run' fame. We took much longer to say what Bill Gross says above in sixteen words. To wit, that there are visible long term ebbs and flows in how stocks are priced, and that stock weighting policy decisions should be framed in that 'ebb-and-flow' pricing context. The value of this perspective is clear in Table 1 (see next page).

- We have been living in the *Post-Bubble Blues* investment regime since 2000. It is the seventh coherent regime since the early 20<sup>th</sup> Century.
- These regimes, while each unique in its own way, do have an 'ebb-and flow' to them, alternating between pessimistic and optimistic market mindsets. This dynamic is consistent with the evolution of capitalism where successes lead to excesses, which lead to periods of retrenchment, which in turn set the stage for the next round of successes...
- The duration of these investment regimes has been ten to twenty years. Based on this evidence, we could be nearing the end of

the nasty *Post-Bubble Blues* regime...or we could be only half-way through it.

- Dividend yields fell over the course of the optimistic regimes, and rose during the pessimistic ones.
- Realized equity risk premiums were giddily positive during the optimistic regimes (+8 to +12% per annum), and depressingly negative during the pessimistic regimes (0 to -9% per annum).
- Dividend yields trended downward over the six 20<sup>th</sup> Century regimes, declining to a measly 1% at the end of *Pax Americana II*. This upward trend in the valuation of dividend payments gave total stock returns a nice boost in the 20<sup>th</sup> Century (about 2.5% per annum in price appreciation). Unfortunately, this is a two-way street. The *Post-Bubble Blues* experience is painfully confirming that, the lower the starting dividend yield, the steeper stock price declines must be when increasing pessimism requires a larger forward-looking equity risk premium.

This last point is critically important today, and we elaborate further, using Table 2 (see next page).