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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

I have told the folks I have met with 2014 is going to be a tough one. Based on what we know now, by the time we are blowing horns and drinking champagne on New Year's Eve, the US stock markets should be slightly positive for the year. Obviously, a lot can change over the next 12 months, but there aren't any tea leaves suggesting an imminent economic collapse or sharp drop in corporate earnings, at least not in my cup. Still, there will, or should be, a fair amount of volatility, which could be gut-wrenching at times.

If I have said this once, I have said it on no fewer than 20 different occasions. Thus far, although only one month into the new year, I have gotten the gut-wrenching part right. The slightly positive? Not so much, but we still have 11 months left to go.

In my opinion, the problem with the market has less to do with contemporary corporate earnings and economic data than it does the market's performance in 2013, when the S&P 500 rallied over 30%. Think of it this way: imagine through some fluke in the scheduling process, your team plays the same opponent two weekends in a row, both times on a neutral field. The first weekend, you crush them, and I mean you really blow them out. It was as though men playing against boys, little weak boys. So, what are your expectations for the next weekend? Another blowout? Or at least it won't be terribly close.

Now, what happens when the game is closer than you, or anyone else, expects? While the outcome was never really in doubt, instead of a rout, your team wins by an unsubstantial margin, and they don't look real red hot in doing so. In fact, had a couple of plays gone the other way, you never know what might have happened. How do you feel then? Even though your team has posted back to back wins? Are you feeling good about things moving forward?

Such is the case with the markets in January. Frankly, I think it stinks.

Currently, investors are paying $16.55 for every $1 of reported profit in the S&P 500. This is also known as the Price/Earnings ratio. So, if you "get back" $1 for every $16.55 you pay, that works out to be a "return" of 6.04%, which we call the Earnings Yield. But how does that compare, and to what?

Based on daily observations, the average Price/Earnings ratio on the S&P 500 from 1/29/1954—1/31/2014, a span of 60 years, was/is 16.39. Therefore, if you are investor 60 years old or younger, you have, on average, paid $16.39 for every $1 of profit in the S&P 500 since you have been alive. That works out to be an Earnings Yield of 6.10%.

So, the difference between 6.04% and 6.10%? Well, for most people, that probably wouldn't be enough to change banks or brokers. As such, based on this one metric, it would

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Being an entrepreneur is hard. Having supportive and caring investors helps.

Fred Wilson

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seem the S&P 500 is, you know, not necessarily overpriced. It is about average. Now, where we come up with that 14-15 P/E the talking heads always bandy about, I'll never know. I literally did the math, and the math was 16.39 over the last 60 years.

But how do we use this number? What does it mean? Well, you use the Earnings Yield to compare your "return" against other asset classes, notably bonds. What kind of return does, say, a 10-Year US Treasury Note offer you by comparison?

Well, unfortunately, my Bloomberg has daily yields on the 10-Year Treasury Note going back only to 1/5/1962, which isn't 1954, but still a healthy 52 years with of information. Since then, through today, the average yield to maturity of this particular security has been 6.51%. Hmm. Interesting, but what if we did an apples to apples, and calculated the P/E and Earnings Yield on the S&P 500 for the exact same time frame? What would that tell us?

Okay, for those same dates, the P/E on the S&P 500 has been 16.56, and the earnings yield would be, drum roll please, 6.04%, which is the same as today. However, as I type here on 1/31/2014, the yield to maturity on the 10-Year US Treasury ain't anywhere near 6.51%. Nope; how does 2.67% strike you? As such, it would seem investors currently love debt far more than they love US equities, at least by this measure.

After all, to get an Earnings Yield on the S&P 500 of 2.67% the P/E ratio would have to skyrocket to, get this, 37.5! Obviously, that is comfortably more than double where it currently is. As such, if history were currently holding true, either interest rates would be significantly higher OR the S&P 500 would be around 4,000.

Of course, this time is different, and all of that. Right? I suppose so, but, where the rubber meets the road, for all the talk to the contrary, you know, Americans have become a more risk averse lot, particularly young Americans. Let me explain.

The Kaufmann Foundation tracks entrepreneurial activity in the United States better than just about anyone else. Here are some of its highlights from 2012:

> "Although the entrepreneurship rate declined for high school dropouts from 2011 to 2012 (0.57 percent to 0.52 percent), this group has the highest rate of business creation, which may be due to more limited labor market opportunities than for more highly educated groups."
>
> "The youngest age group (ages twenty to thirty-four) and those ages forty-five to fifty-four experienced large decreases in entrepreneurial activity from 2011 to 2012. An aging population has led to a rising share of new entrepreneurs in the fifty-five to sixty-four age group. This age group represented 14.5 percent of new entrepreneurs in 1996, whereas it represented 23.4 percent of new entrepreneurs in 2012."
>
> "The immigrant rate of entrepreneurial activity decreased from 0.55 percent in 2011 to 0.49 percent in 2012. However, immigrants were still nearly twice as likely as the native-born (0.26 percent) were to start businesses each month in 2012."

As a point of reference, the rate of entrepreneurial activity in 2012 was .30%, or 300 entrepreneurs per 100,000 population.

Now, with those 3 bullet points above in my mind, consider what the numbers for 1996 were:

- Entrepreneurial rate for high school dropouts in 1996 (the first year of the data by the way) was .39%. By comparison, the rate for college graduates was .30%, and .32% for people with some college related coursework. In 2012, the rates were .52%, .28%, and .28% respectively.
- In 1996, the entrepreneurial rate for 20-34 year olds was .28%. For 35-44 year olds, it was .30%. 45-54

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came home at .36%, and 55-64 was .32%. In 2012, these numbers were .23%, .34%, .34%, and .34% respectively.

- Finally, in 1996, the entrepreneurial rate for immigrants was .36%, and for native born Americans it was .30%. In 2012, these numbers were .49% and .26%.

Hmm. There has to be a lesson in here, and there is: it seems the more educated "we" become, the more risk averse our society becomes. The reason for that is probably because people with a higher degree of education have and realize they have "more to lose," and, therefore, are less inclined to take "unnecessary" risk.

If not that, how about: native born, college educated Americans, under the age of 35 are the most risk averse demographic in our society. Unfortunately, this is the EXACT group which should be the most comfortable with developing technology, and which should be leading a tech start-up and tech-led manufacturing revolution. As this doesn't seem to be happening, what gives?

Well, it gives because bank credit standards have become more stringent thanks to new regulations and "consumer protection" rules. Further, as people tend to become more risk averse in their investing as they age, or have been throughout history, older folks are more apt to focus on asset classes they "understand," and which don't carry too much perceived risk. Ergo, the apparent overriding preference for bonds, and even stocks to a much lesser degree.

As a result, it would seem the credit spigot to young, would be entrepreneurs is about as dry as it has been in my professional career. Those entrepreneurs we have "out there," tend, increasingly, to be: 1) immigrant, and; 2) lacking advanced degrees, and; 3) heavily focused on construction or "service" related industries, and; 4) employing fewer people than previously.

That isn't to say that is the case with ALL entrepreneurs; it isn't. However, it IS enough of a problem to warrant some attention from policymakers, that is IF they care about people who probably won't vote next election anyhow. Whew. But how have we gotten here from where we started?

It is kind of easy: because an oversized percentage of our nation's investable balances is concentrated in an increasingly risk averse group, as is evidenced, to some degree, by the overbought bond market, in general, and the Kaufmann data, shifts in this group's psyche will have an exaggerated effect on market conditions. Owning to last year's nothing short of fantastic return, this group was probably looking for an excuse to sell...and we have had a gracious plenty thus far in January. Voila. When it gets low enough, they will jump back in, and this dance could possibly take us all the way through to our champagne toasts on New Year's Eve.

Those that don't play the game will be ambivalent about 2014. Those that do prove to have a large capital gains tax bill thanks to, again, 2013.

Disclosure