

Connolly Report

"From 1946 to 1997, dividends per share grew at a real annual rate of 2.2%"
Dividends outpaced inflation.

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Dow 36,000

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Are stocks dangerously overvalued? According to James K. Glassman and Kevin A Hassett writing in the September, 1999 issue of *The Atlantic Monthly* and in the newly published book *Dow 36,000**, stocks are not overvalued. Prices could "quadruple" tomorrow and still not be too high. In March 1998, when the Dow stood at 8782, these authors unveiled their theory in the *Wall Street Journal*. They see the Dow index rising to 36,000 or even higher." Hence the "quadruple" and their title. In *Dow 36,000*, Glassman and Hassett rail against the traditional indicators of value: dividend yield and price-to-earnings ratio. These measures are "limited, shortsighted and anachronistic", they allege. "The overvalued signals these two indicators have been flashing for many years are woefully mistaken." The market, they affirm, is in the middle of a one time rise to a point they call a "perfectly reasonable price" for stocks. At this point, the risk premium for equities disappears: at this point the cash flow from a bond and a stock will become equal...because, these authors maintain, "Equally risky assets should produce equal returns"*.

For most investors, the jury is still out on whether we are into a new paradigm or a huge bubble. I believe that *Dow 36,000* will turn out to be the equivalent to that famous 1929 article in *The Ladies Home Journal* called "Everyone Ought to be Rich". Indicators such as P/E ratio and dividend yield, tested over scores of decades, are still valid. We are/were in a bubble, depending upon whether you look at internet stocks or ours. Ten years ago, remember, American investment bankers were telling us the Japanese calculated their P/Es differently, that Japanese stocks selling at 65 P/E were cheap.

Yield + Dividend Growth

Even though I do not buy the Dow 36,000 theory, I was quite excited about this book because so few people value common stocks the way I do: add dividend yield and anticipated dividend growth. In this regard, Glassman and Hassett are accurate. My excitement was curtailed, however, when I got to the second last chapter where the authors discussed asset allocation. Included were statements like this one on page 256: "shifting slowly from stocks to bonds as you get older". Glassman and Hassett bought the industry line on asset allocation: switch to bonds in retirement.

If upon retirement you own stocks bought years ago and these stocks now provide above market yield (the yield on a 10 year government of Canada bond is a good standard), why would you sell? Why would you trigger capital gains and then compound your stupidity by purchasing an asset with a lower yield and static income...a bond? It's conventional wisdom, but it's tosh. Stick with the growing income on an asset which was purchased years ago: with time, it's safe. Want the ultimate security? When it doubles, sell half and get your money back. At 7.2%, it doubles in a decade.

Most people don't, but Glassman and Hassett understand dividend growth and did an excellent job of explaining the concept. However, by advocating switching to bonds upon retirement, they missed putting the icing on their own cake. It's not the return (yield + capital gain) that's important, it's the income the investment throws off...the yield + dividend growth that matters. It's the yield on your original investment years from now that's important. Because capital will increase too, if we had to we could, but retirees would rather not eat into capital in retirement. We prefer to live from income and favour a growing income.

*You can obtain elaboration of the Dow 36,000 theory from their *Wall Street Journal* articles: <http://dow36000.com>