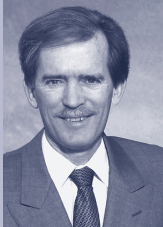


Bill
Gross



Investment Outlook

P I M C O

September 2002

Dow 5,000

Okay, so what's a bond guy doing talking about the stock market again? Shouldn't he stick to his "knitting?" Isn't he really just an equity transvestite in disguise? A frustrated stock wannabe who couldn't get a job in the early 1970s and took the best thing he could find – A Bond Manager? Yeah, well maybe, but then again maybe you owners and managers of stocks could benefit from a different perspective. We already "know" bonds are going to yield/return 5% or so over the next umptyump years. How about asking the same question for stocks? Afraid of the answer?

My message is as follows: stocks stink and will continue to do so until they're priced appropriately, probably somewhere around Dow 5,000, S&P 650, or NASDAQ God knows where. Now I guess I'm on somewhat of a rant here but come on people get a hold of yourselves. Earnings have been phoned up for years and the market still sells at high multiples of

phony earnings. Dividends and dividend increases have been miserly to say the least for several decades now and you've been hoodwinked into believing the CORPORATION should hold on to them for you so that they can convert them into capital gains and save you taxes. Companies have been diluting your equity via stock options claiming that management needs incentives of millions of dollars just to get up in the morning and come in to work. Then they pick you off by trading on insider information, selling shares before the bad news hits and you have a chance to get out. If you try to get a hot IPO you find all the shares are taken – by Bernie Ebbers. Come on stockholders of America, are you naïve, stupid, masochistic, or better yet, in this for the "long run?" Ah, that's it, you own stocks for the "long run." We bond managers may have had a few good relative years but who can deny Stocks for the Long Run? Not Jeremy Siegel, not Peter Lynch, maybe not

even Bill Gross if you stretch the time period long enough – 20, 30, 40 years. But short of that, stocks can be, and often have been poor investments. The return on them depends significantly on their beginning valuation and right now valuation remains poor. Dow 5,000 is more reasonable. Let's see why.

To present my case I resort to a panel of expert witnesses, academicians and financial theorists with a lot more brainpower than I have. Over the past several years, in contrast to the more bullish and optimistic Jeremy Siegel, or Jim Glassman of Dow 36,000 fame, there have been several more realistic and down to earth experts that speak to low, not high, equity returns over the foreseeable future. Their primary thesis is not that the U.S. economy is headed for a depression or that the economic sky is falling but that even under near normal economic growth rates, the U.S. stock market is priced at current levels to return less than has been historically "required." Grow those earnings they say (although let's be sure what they are) at near historic rates and you'll still need much lower prices in order to offer stock investors a chance at returns that exceed corporate bonds or even inflation protected Treasuries – TIPS.

Many of you readers may be familiar with Peter Bernstein via his books on risk or even gold, but recently he teamed up with common sense and actuarial wizard Rob Arnott to produce a brilliant piece of research entitled What Risk Premium is Normal? In addition, the trio of Elroy Dimson, Paul Marsh, and Mike Staunton have written a book that may have equaled or perhaps surpassed Siegel's, as well as Ibbotson and Sinquefelds' study of world wealth, with their Triumph of the Optimists, a 101-year survey of investment returns. I shall refer to both sets of authors frequently over the next few pages.

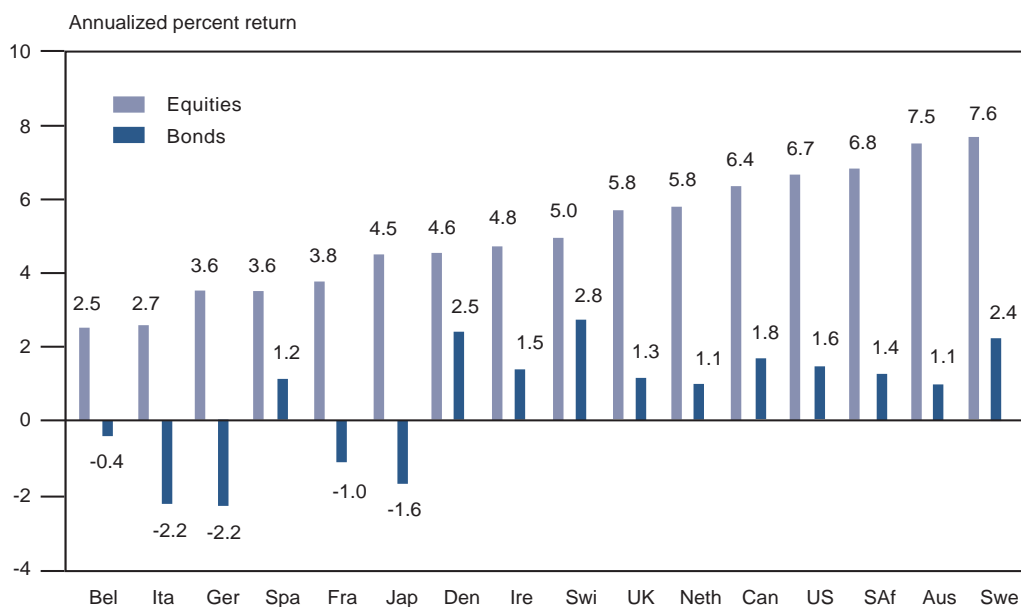
Let me say first of all that it is difficult to keep this simple. I've read, reread and near-memorized both of these research gems. Their contents seem simple to me now but they were not at the beginning, so I must assume the same for most of you. Besides, you have minutes not months to get my drift, and if I am to help you I must inform you quickly and yet simply, even leaving some critical think pieces out, in order to do so. Forward. The crux of the valuation argument is this: Stocks historically return more than almost all other alternative investments but only when priced right

when the race begins. If you start from day one with P/E's too high or importantly, dividends too low, you will not obtain equity returns in excess of bonds. Seems simple enough. People know that if they pay twice the market price for their house, that it will take years and years to get their money or their equity out. Somehow though when it comes to stocks they forget.

Maybe they forget because it's hard to know at any point what a stock or a stock market should be worth. Here's some help. Jeremy Siegel, "DMS" (author's Dimson, Marsh and

Staunton), as well as "B&A" (Bernstein and Arnott) all pretty much agree that over the past 100 years U.S. stocks have provided a real return (after inflation) of about 6.7%. While that return has been higher than for most other countries shown in the "DMS" chart below, in none of the countries did stocks fail to outperform bonds over the past century and that includes several stock markets, which virtually disappeared during WWI and WWII. The average real return for the 16 countries shown was 5.1%. Remember that these returns are ex-inflation, so that arguments for higher nominal returns in inflationary periods

Real Return on Equities Versus Bonds Internationally, 1900-2000



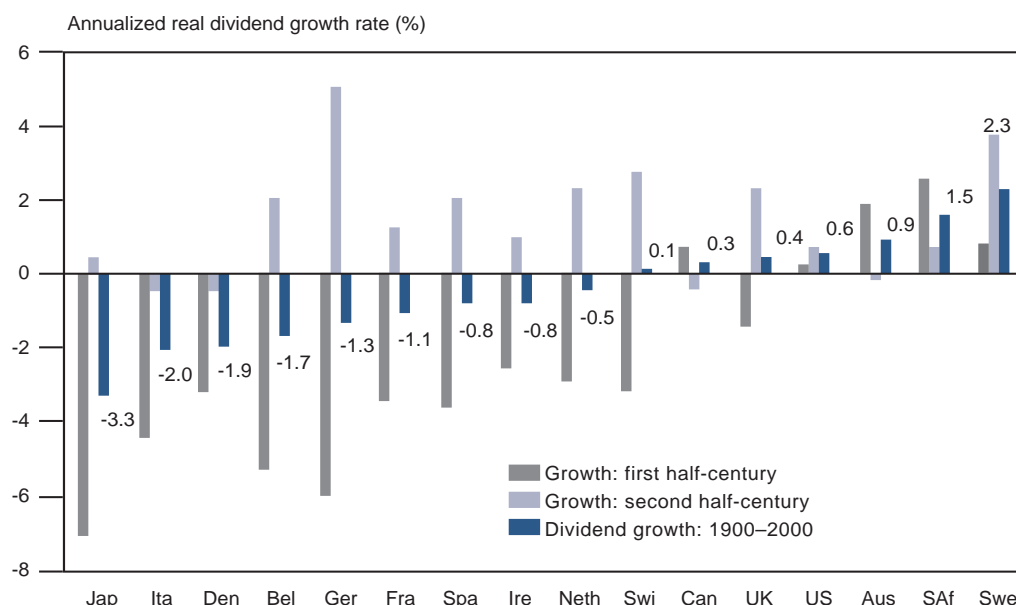
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and lower nominal returns during times of low inflation are neutralized.

Using the commonsensical approach that “100 years of the past” is “100 years of prologue” an investor might reasonably expect to have future real returns come close to 6.7% in the U.S. and 5.1% globally. Remember though, to get those same returns with similar economic growth you have to start at the same valuation point as an investor did in 1900. Maybe the market was super cheap then and very expensive now. Makes a difference, and as you’re about to find out, that was exactly the case. Although 1900’s stock market would provide 6.7% real

over the next century, turns out it was because of some reasons that you probably wouldn’t think of right off the top of your noggin. Most investors would say it was because earnings grew that much, so stock prices just naturally followed like a little puppy dog at the heels of its master. Wrong. The two primary components of this 6.7% real return were 1) a beginning dividend yield of 4.2% and 2) rising valuation (P/E’s going up). Real earnings growth, or its twin, real dividend growth, comes in a poor third. Over those same 100 years, real dividends managed to grow at only .6% as seen in the “DMS” chart below.

Real Dividend Growth Rates Around the World: 1900-2000



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Ninety percent of the market's real return then came from factors other than earnings growth. Most of it came from the initial dividend yield.

And so dear reader, in an attempt to keep this simple and help you to plough through what can get most complicated, the primary element in determining how a stock market is priced – whether it's cheap or expensive – is its yield. At 4.2% in 1900, the market needed an additional 2.0% annual push from a tripling of P/E ratios over the century to get near that 6.7% real return. Earnings growth was a pathetically small factor. How could that be? As Peter Lynch said in a recent CNBC interview when asked about the future of the stock market, "Well, since WWII corporate profits have grown about 8 or 9 percent a year...I don't see why that won't be different the next 50 years," implying that stock prices would do the same or more. The problem is, as Peter Bernstein points out in an August 2002 research piece entitled The Trouble With Earnings, at least 50% of the earnings growth over the past 40 years has been earnings of the "mystical" kind – pro forma, operating, phoned up. Those "earnings" didn't flow through to dividends. In addition a goodly portion of Lynch's

8-9 percent – and the faster portion it turns out – has come from newly created companies that are not even listed and available for purchase by outside investors. The balance after subtracting 4 percent inflation... has been near the .6% real growth of the past 100 years or the .8% of the past 50 years. You are being hoodwinked America. You pay your money and you gets...you gets...a dividend yield and a little bit of dividend growth: .6% real over the last 100 years.

Where does that leave us (you – not me – I'm out of the market) today? Well, most large market indices (NYSE, Wilshire 5000) yield somewhere in the area of 1.7%. Whoa now, did I say 1.7%? Yes siree. And despite the claims for higher implied yields due to stock buybacks (mostly fallacious) even if we grant an "implied" yield of 2.0% to the market, it's hard to see how we can get to our 6.7% real return target. Say real dividends grow at 2.0% for the next 100 years instead of .6%. Not sure why that would be but let's just say that to be more than fair. If so, then a 2% implied dividend yield, plus 2% real dividend growth, only equals 4% - far short of our hoped for or perhaps required 6.7% of the past 100 years. How to get there? Well, absent faster economic growth

which would lead to even higher dividend growth than I've already generously granted, the only way to make that happen is to start with a yield of 4.7% and the only way to do that would be to cut the market averages in half or more. Dow 4,000 would do it as would S&P 400.

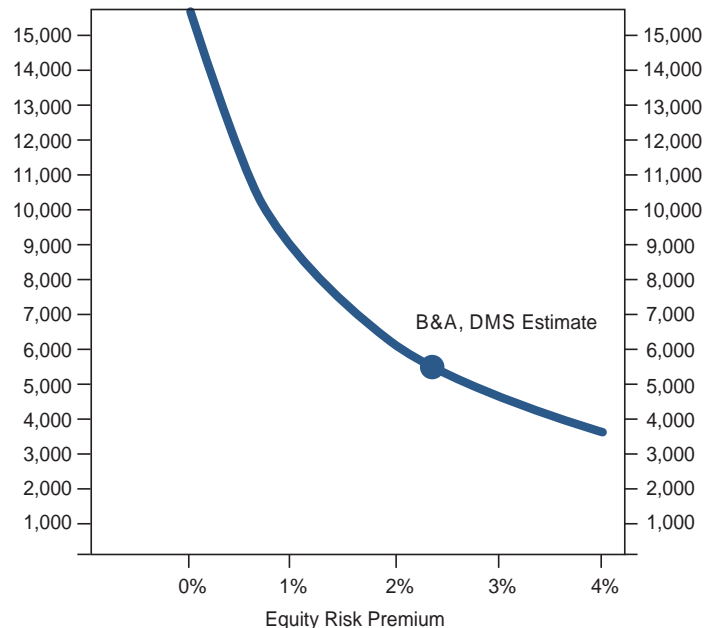
Now to be fair and truthful to B&A and DMS, both assert that the 6.7% real return over the past 100 years should never have been the "expected" return anyway. After all, 2.0% of that 6.7% came from a tripling of P/E ratios which is really not rational to expect again over the next century. A rather unscientific adjustment, which neither DMS nor B&A employ, would be to use the 100-year real return from equities without the tripling effect, or 4.7%. If so, with 2% real dividend growth, stock markets need to yield 2.7% and would fall by 20% in order to get there. At Dow 7,000 or so we would be fairly priced.

B&A and DMS approach it a little differently though, using an historical "equity

risk premium" to get to an appropriate starting point valuation. This equity risk premium is really the excess return that investors require over and above real Treasury yields (best measured by TIPS yielding nearly 3.0%) to compensate them for the increased volatility and increased risk of owning stocks. Both B&A and DMS calculate that risk premium should be roughly 2.4% when measured against 30-year TIPS. Let me though, introduce my final chart that you can play with yourself. This chart's horizontal axis tracks the equity risk premium that you, the investor, would be

Gordon Model Valuation of the Dow ($\frac{D}{r-g}$)

Index level of the Dow (assumes dividend = \$185 and 2% real dividend growth)



The real return you need to earn over and above 30 year TIPS (3.0%) by purchasing the Dow and assuming stock market risk.

satisfied with. Ask yourself this: *How much more real return over and above 30-year Government guaranteed TIPS do you need to compensate you for owning stocks?* If you say nothing, then the sky's the limit – Glassman theorized just this when writing Dow 36,000. If however, you have some common sense and know that even over the long term there's a decent chance of something going haywire – war, depressions, deflation, etc. – then you'll need something more than the government guaranteed TIPS rate of 3.0% to buy stocks. B&A and DMS say it has been and should be an extra 2.4% in which case the DOW is worth 5,000 on this chart. But put in your own number and see what value you get.

If you've got even half of your marbles left, I'll bet you your number is nowhere near today's level of 8,500. That means that in order to get a real return sufficiently higher than 3.0% to meet your "risk premium" requirements the market has to go down before it can go up again. And when it starts to go up again, it's only going to produce inflation adjusted, real returns of 5% over the long run if it mimics what the market has returned over the past 100 years (absent a tripling of P/E ratios). Until then, stocks are losers and anyone who owns too many of them

will be losers too. As Warren Buffett has said, in the short run the stock market is a voting machine but in the long run it's a weighing machine. Despite being down nearly 50% from its highs, this market remains overweight. Forget about "Stocks for the Long Run" until they slim down to the point from which even yours truly can admit that they will outperform the bond market. And if some of this is confusing, just remember this: the market needs to yield close to 3.5% before it approaches fair value, and that means DOW 5,000. While stocks are the best bet over the very long term, they will not be, nor will they beat bond returns until they begin the race from a fair valuation. Since in the short-term the stock market is a voting machine/popularity contest, it's impossible to say exactly when, if ever, this fair valuation mark of approximately Dow 5,000 will be reached. If it doesn't get there however, future real equity returns will be lower than 5%, and a diversified portfolio of government, mortgage, and corporate bonds will be the best performing asset class for years to come. And oh, one large caveat. If the bond market continues to rally and the Fed can successfully engineer a 2% long-term TIPS rate instead of 3%, then stock markets are actually within

10% of fair valuation. That, however, would continue to support the case for bonds as the better performing asset class. Sounds like an opening for a bond geek to write Bonds for the Long Run. Count me out – one book's enough for me.

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