

Presentation to:

PAPERS Forum

The Credit Bubble and its Aftermath-- Stock Market Psychology, Valuation and Returns

Ty Nutt

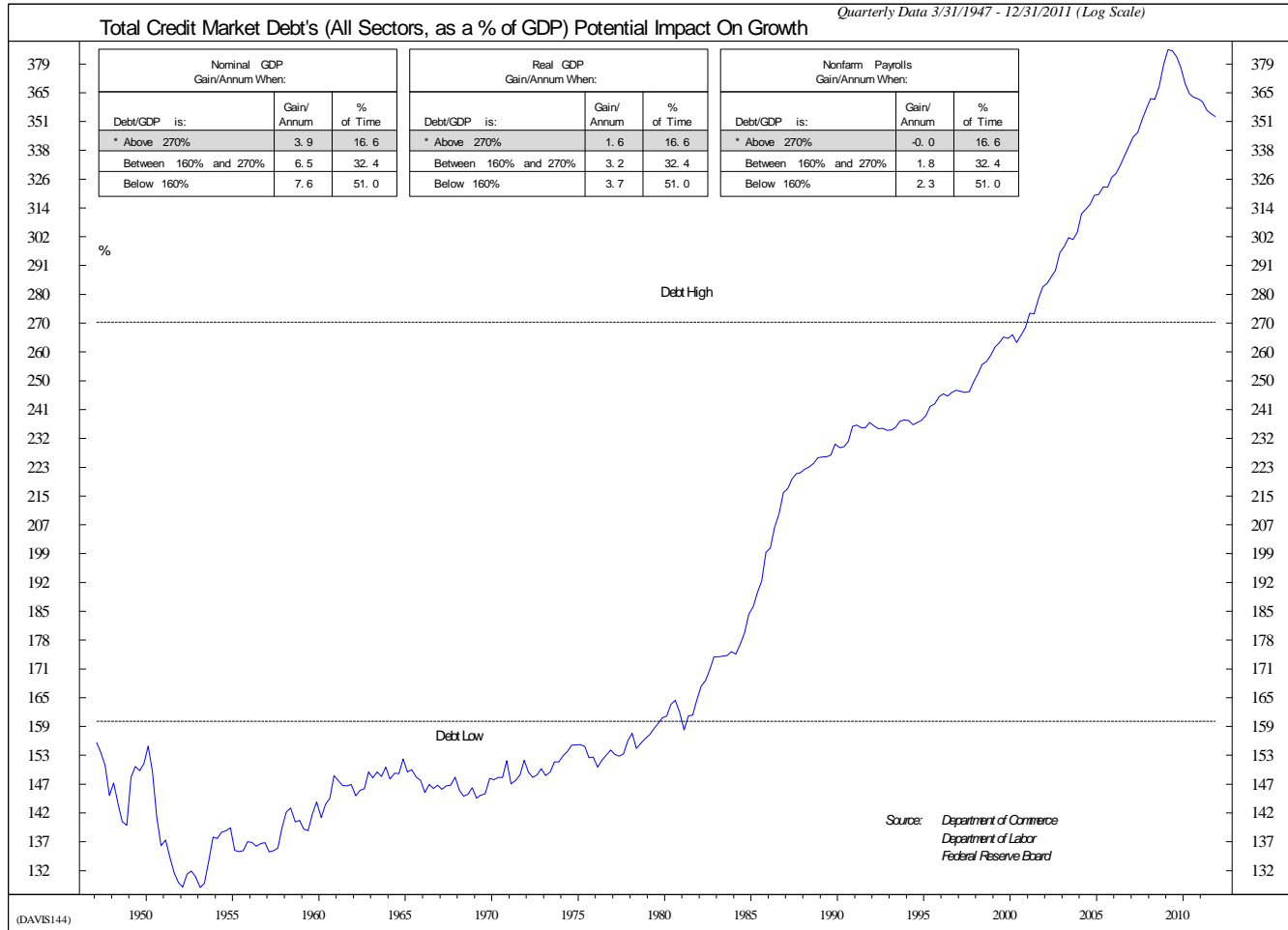
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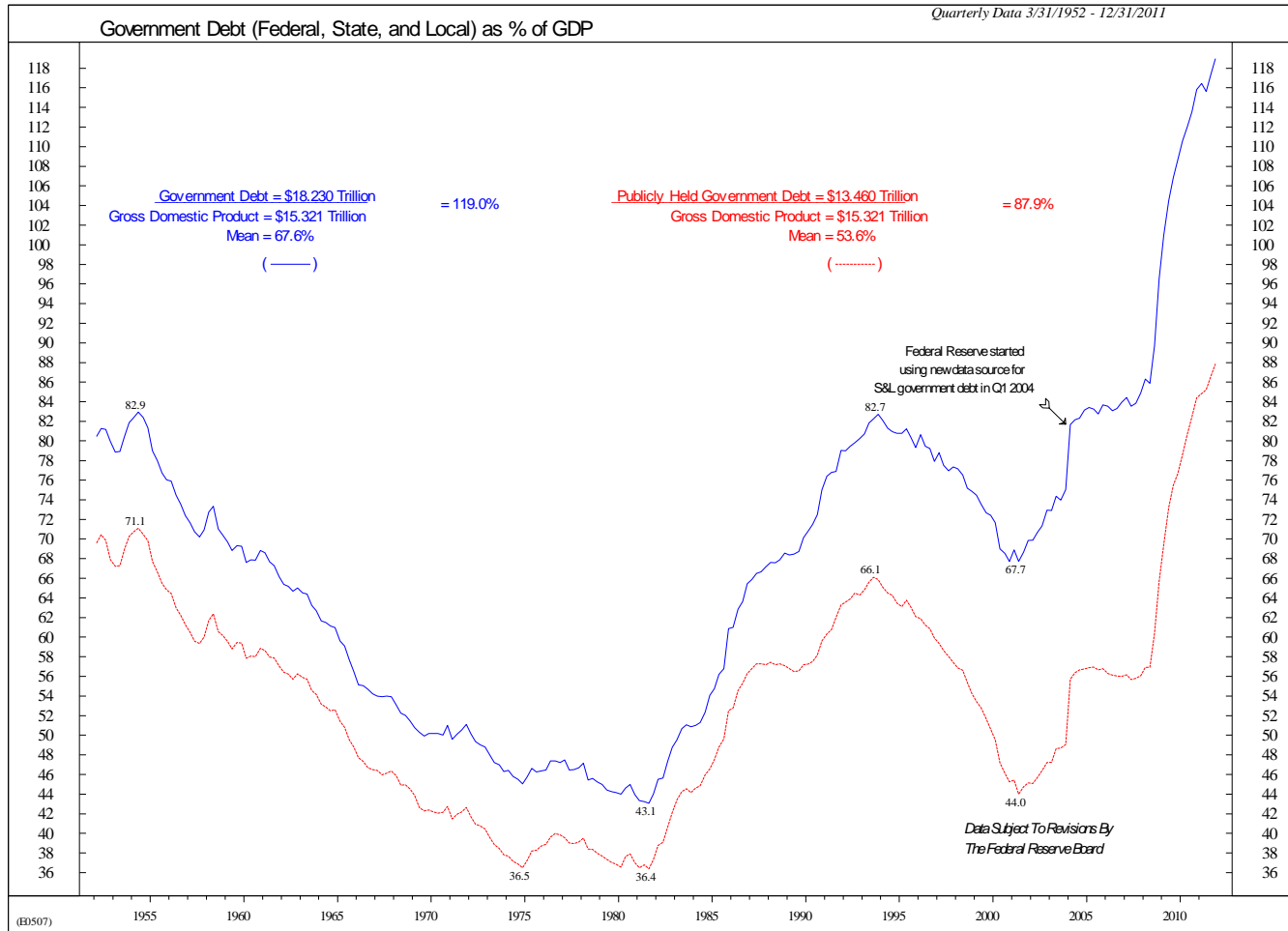
May 23, 2012





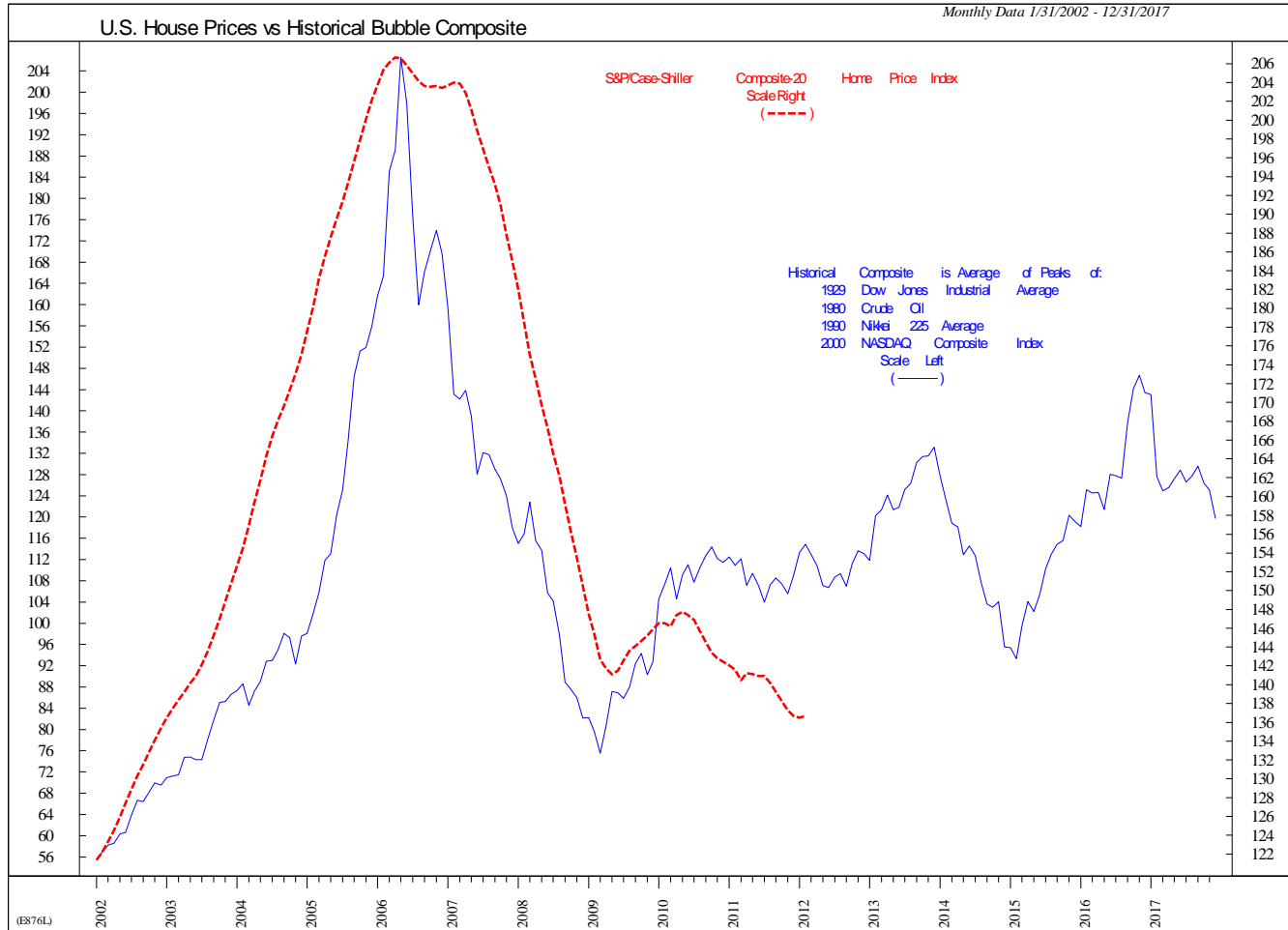
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- Total credit market debt, as a percentage of GDP, remains at high levels
- Higher debt levels have been associated with slower economic growth and lower employment growth during the past 60 years



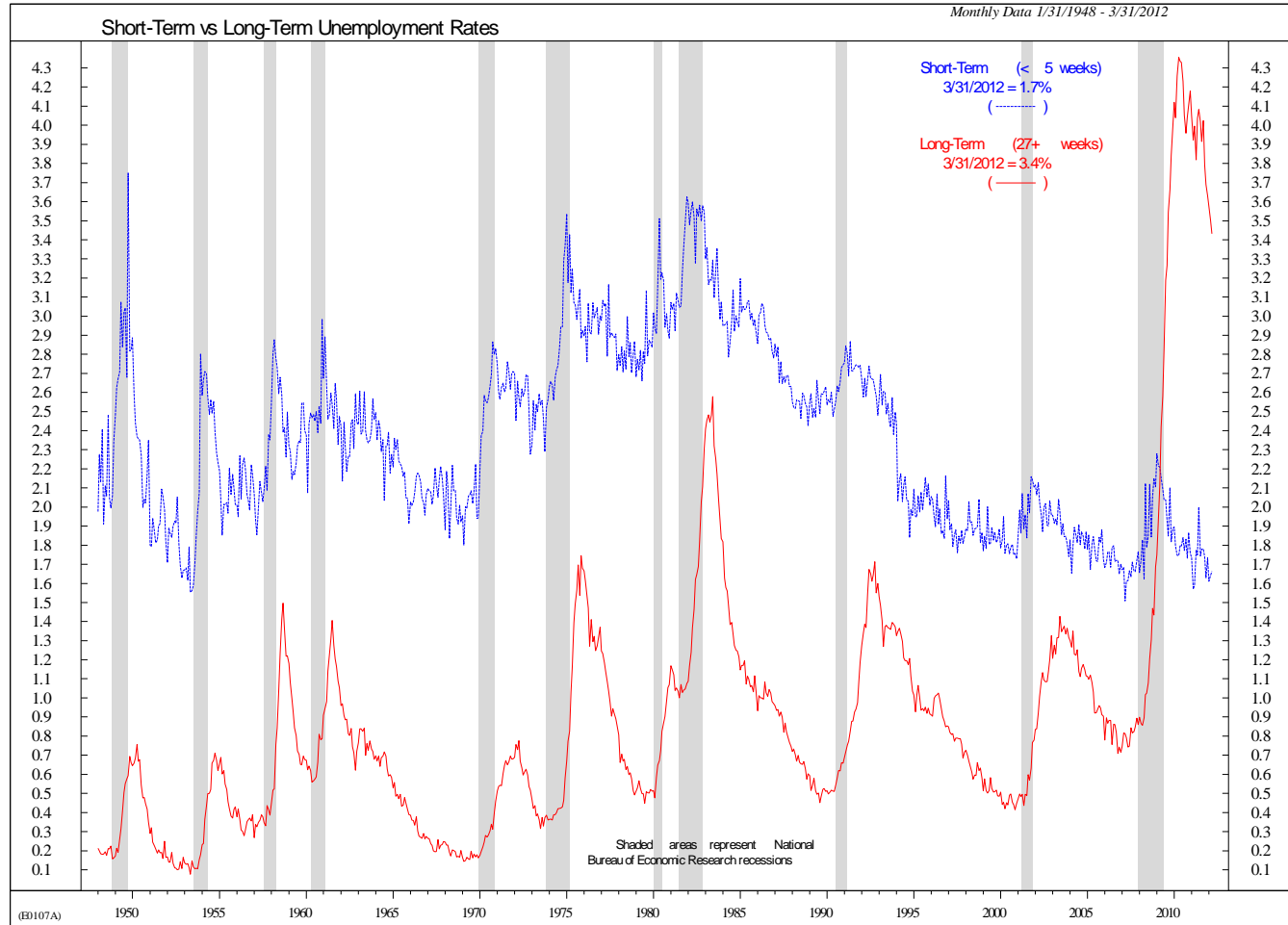
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- Government debt levels are high and rising, and are now 119% of U.S. GDP
- In 4Q 2011, federal debt increased 13% (annual rate), state and local debt decreased 1%



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- The rapid increase and subsequent decline in U.S. home prices has been similar to the pattern of past bubbles



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- Unemployment, especially long-term unemployment, remains a problem
- Approximately 41% of the 12.7 million people counted as unemployed have been out of work for six months or longer

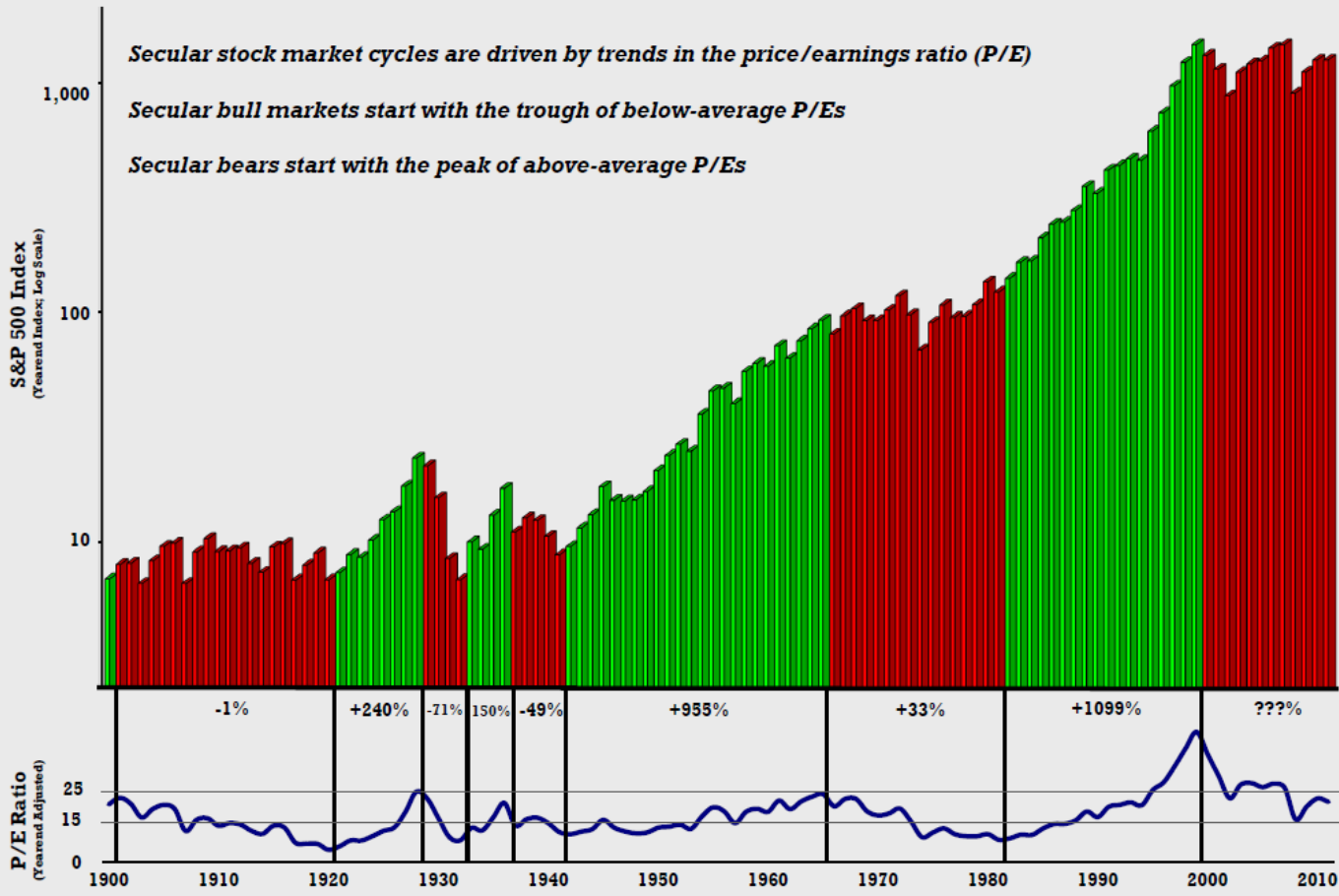


Source: Strategas Research Partners, LLC

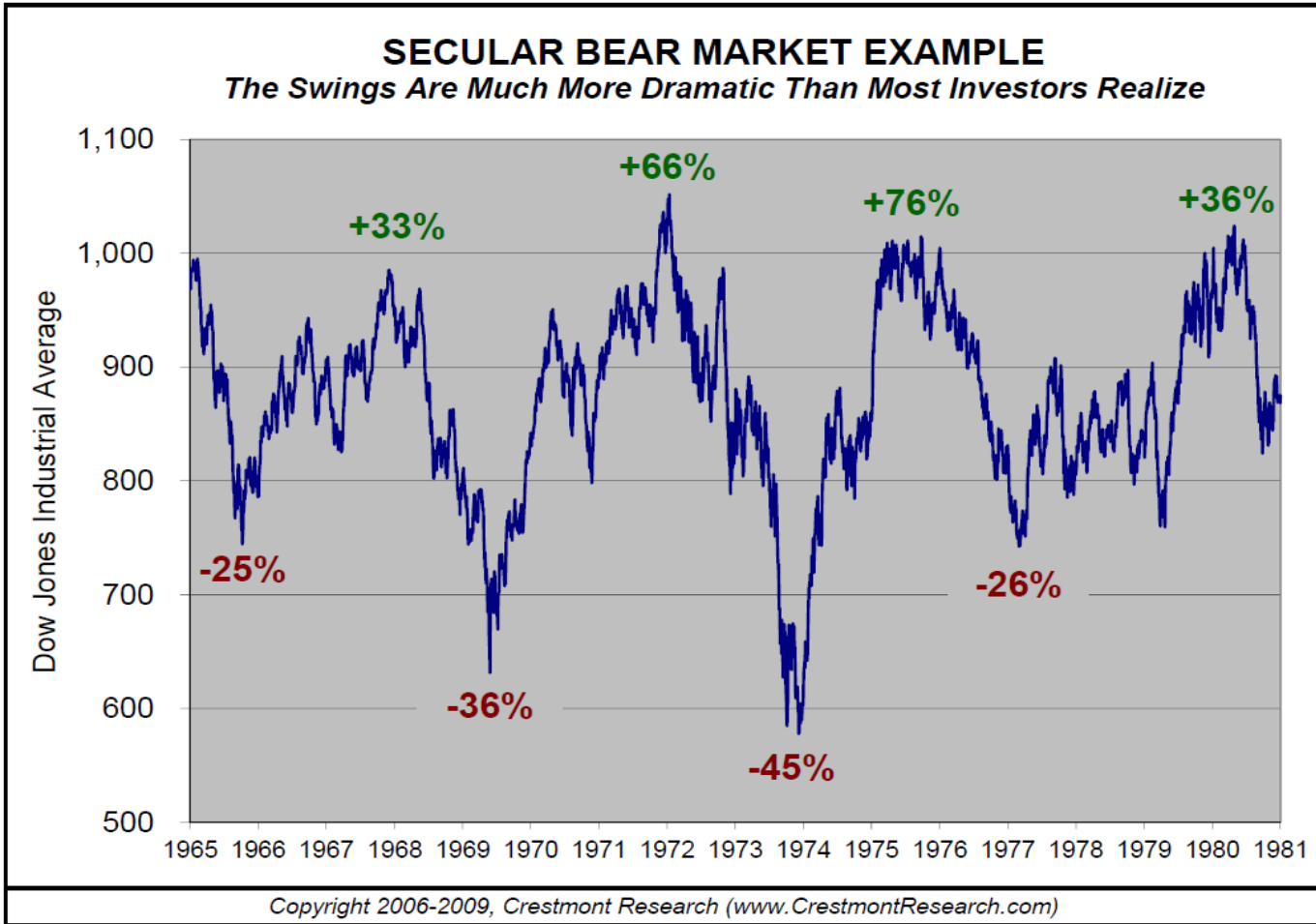
- Since the financial crisis, stocks have responded well to the Fed's repeated attempts to stimulate demand via quantitative easing

SECULAR STOCK MARKETS EXPLAINED

S&P 500 Index: 1900-2011

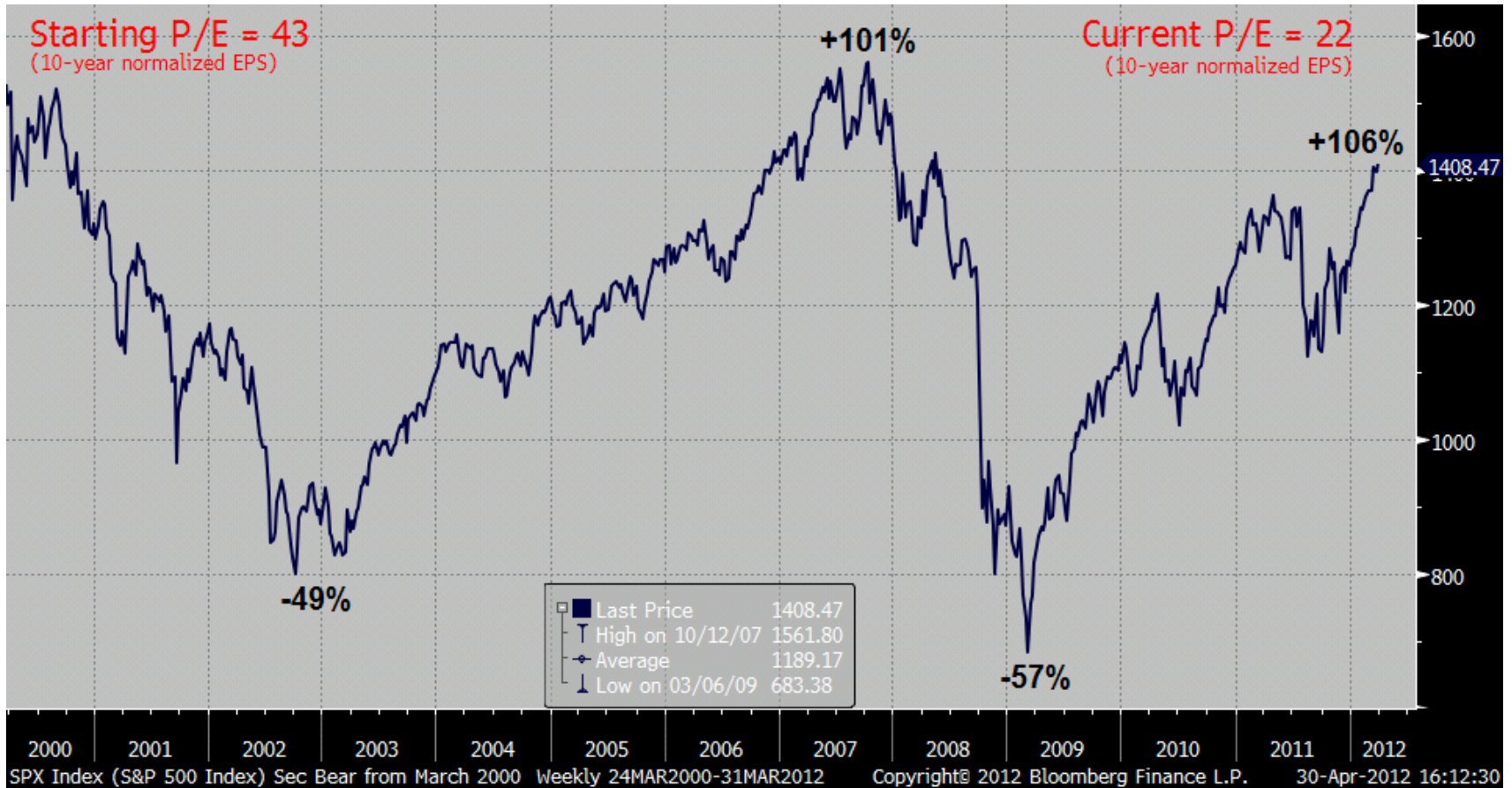


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- Typical of secular bear markets, the DJIA ended the 1965 - 1981 period near its starting level but experienced considerable volatility in between
- While the price low was reached in 1974, the valuation low didn't occur until 1981

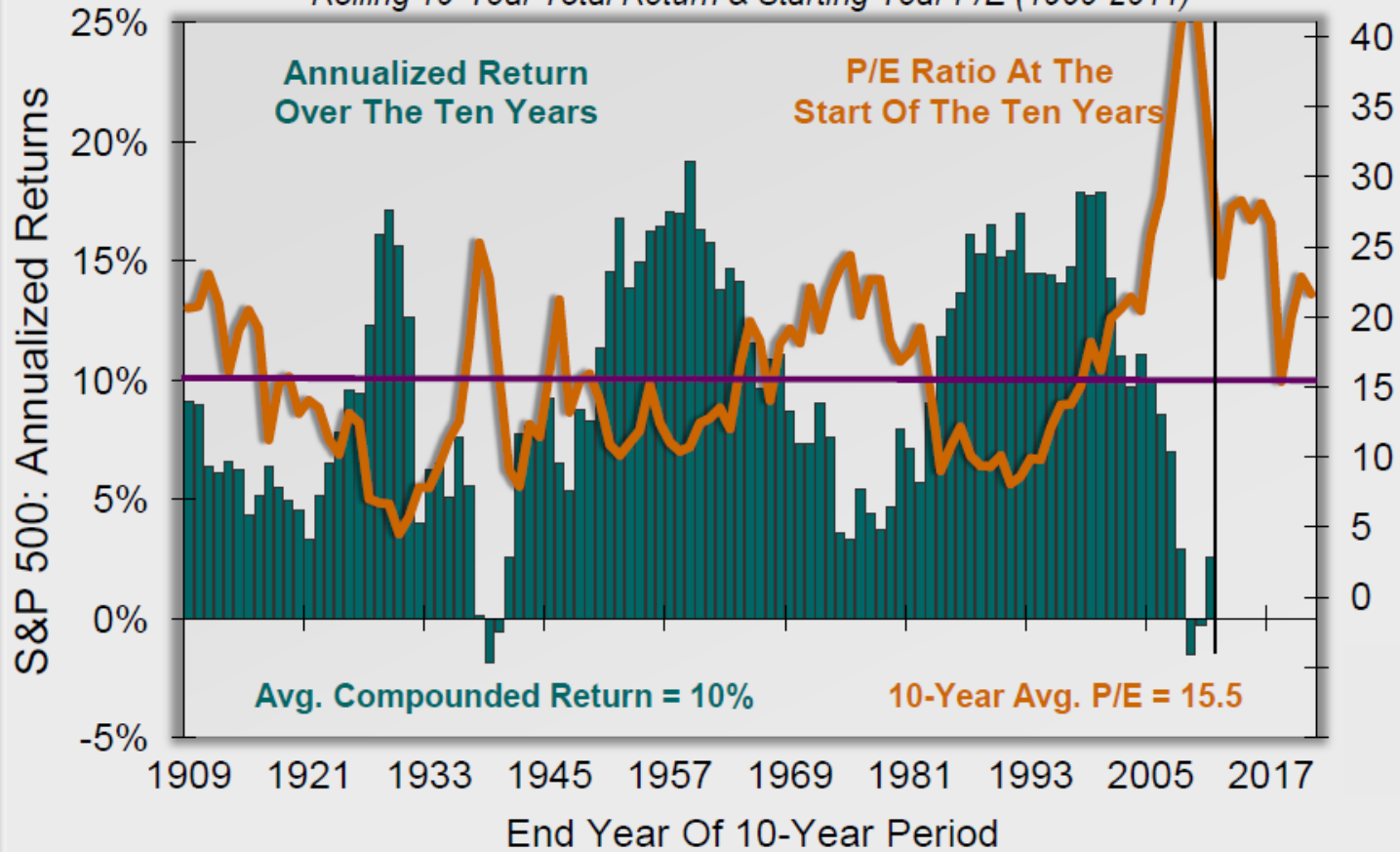
Current Secular Bear Market (S&P 500 Index)



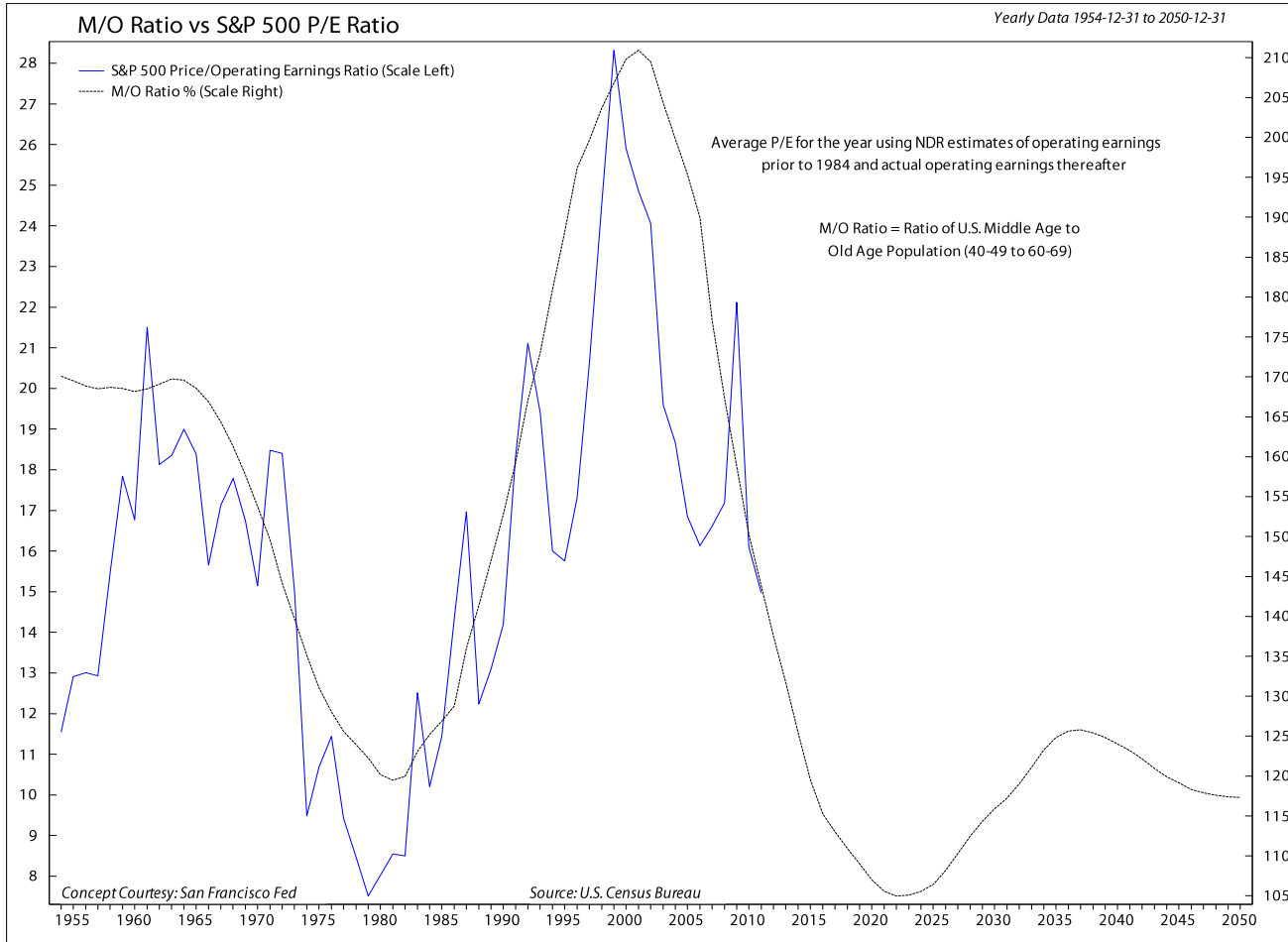
- We believe the U.S. stock market is part way through a secular bear period that began in March 2000
- Despite its very modest return (S&P 500 annualized total return = 1.36% from 4/1/2000 – 3/31/2012), the market's P/E ratio has fallen from 43x to 22x

GAZING AT THE FUTURE: WHY STOCKS ARE UNDERPERFORMING

Rolling 10-Year Total Return & Starting Year P/E (1900-2011)



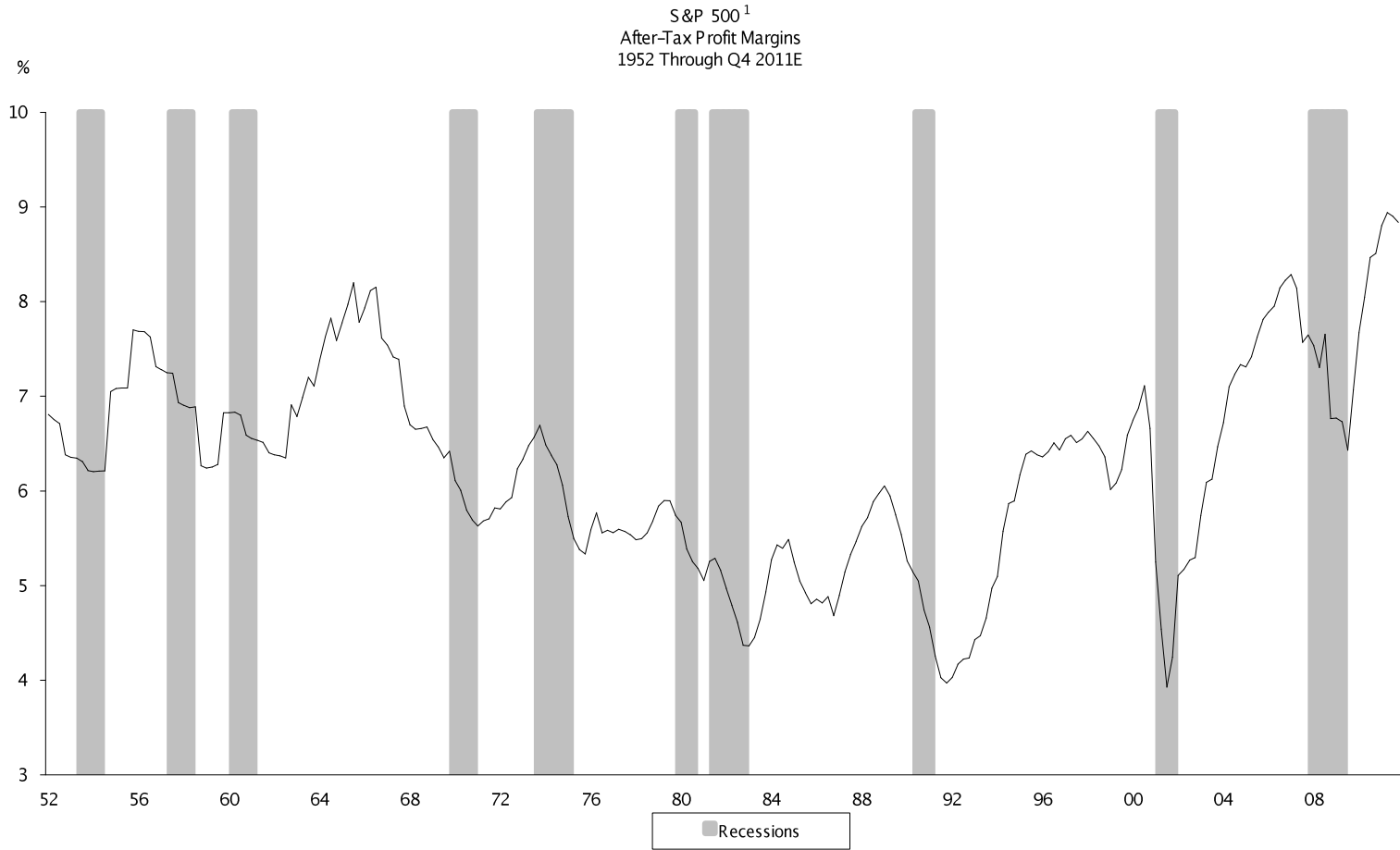
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- Relationship between market P/E and the ratio of middle age to older age population in the U.S.
- In general, an aging population has corresponded to lower P/E levels

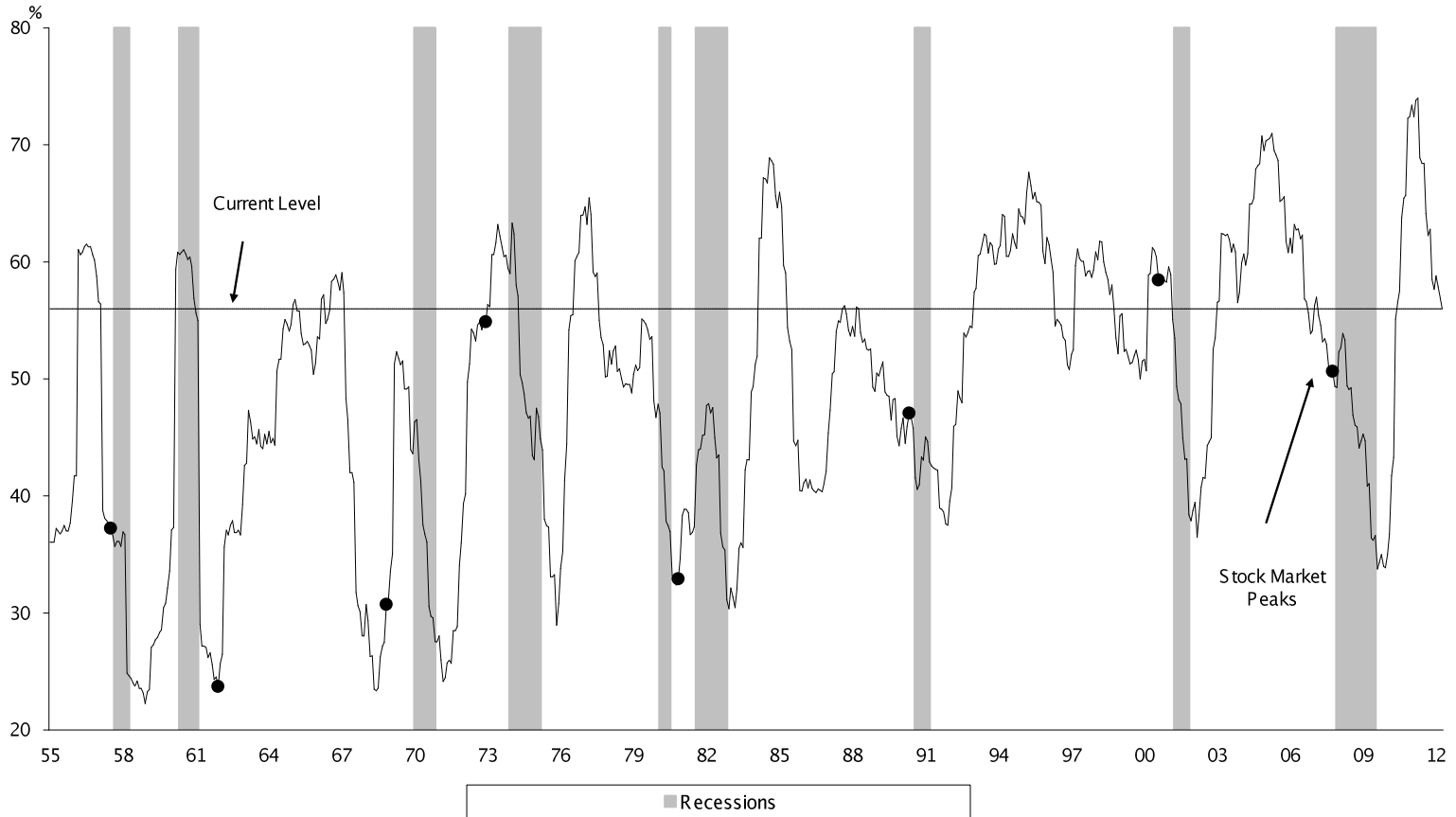


Source: Corporate Reports, Empirical Research Partners Analysis.

¹ Excludes financials. Prior to 1976, the large-cap universe is used.

- After-tax profit margins for the S&P 500 recently peaked at an all-time, post-war high
- Margins have tended to be mean-reverting over time

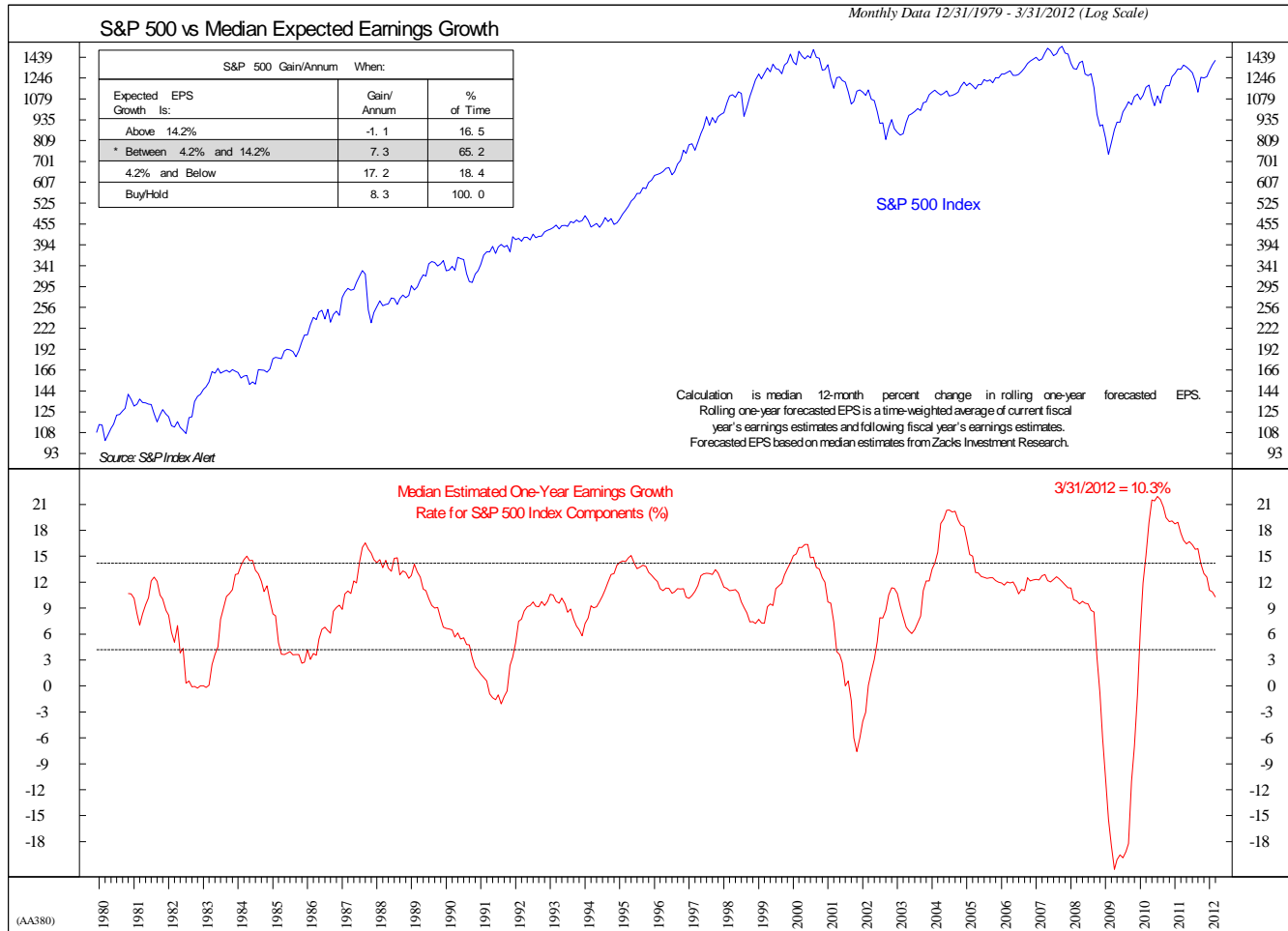
Large-Capitalization Stocks ¹
Share With Improving Pre-Tax Margins
1955 Through Q4 2011



Source: National Bureau of Economic Research, Corporate Reports, Empirical Research Partners Analysis.

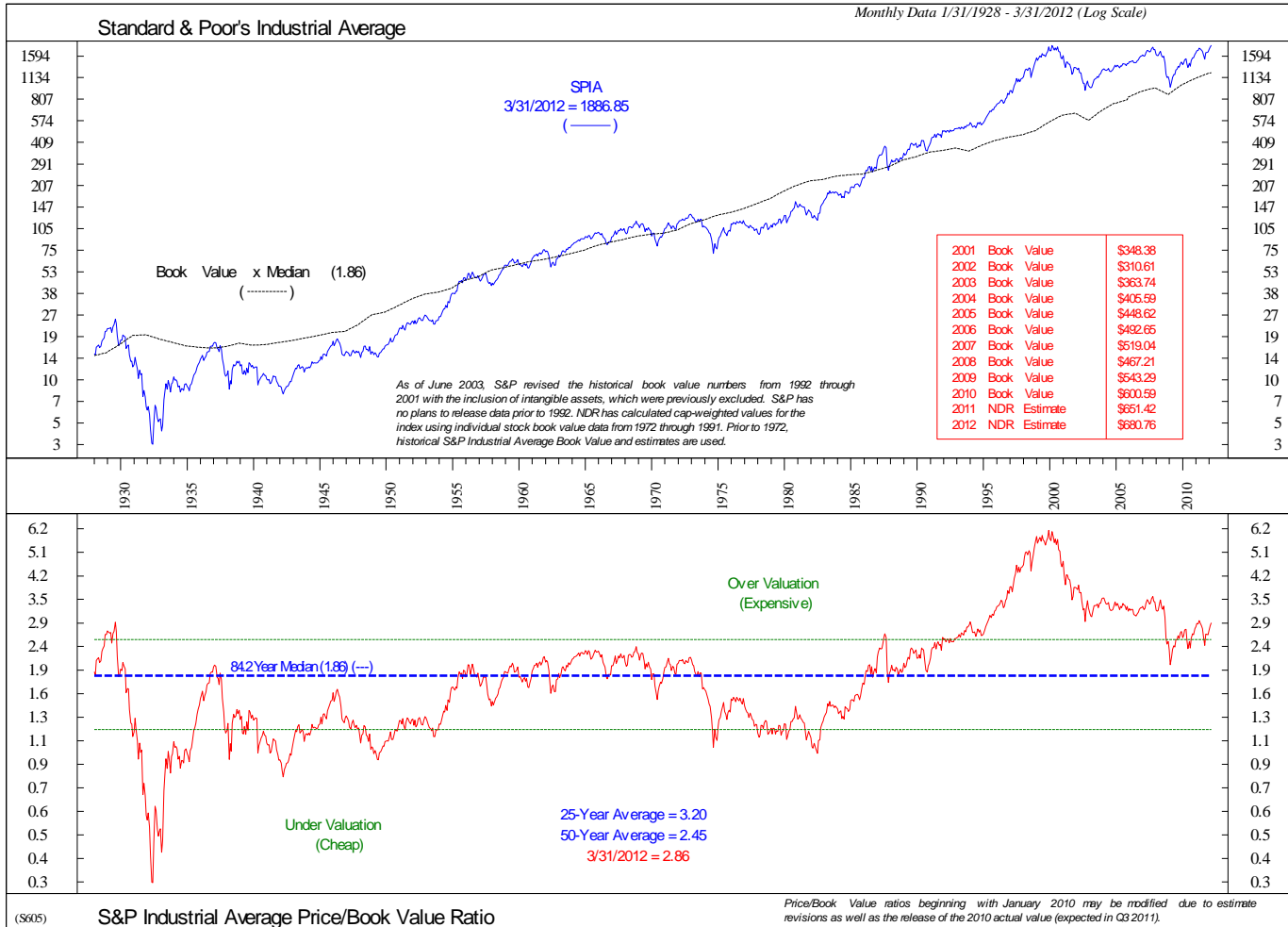
¹ Excluding financials and utilities; trailing twelve-month pretax margins measured versus the prior year.

- The share of large-cap stocks with improving profit margins continues to retreat from peak levels



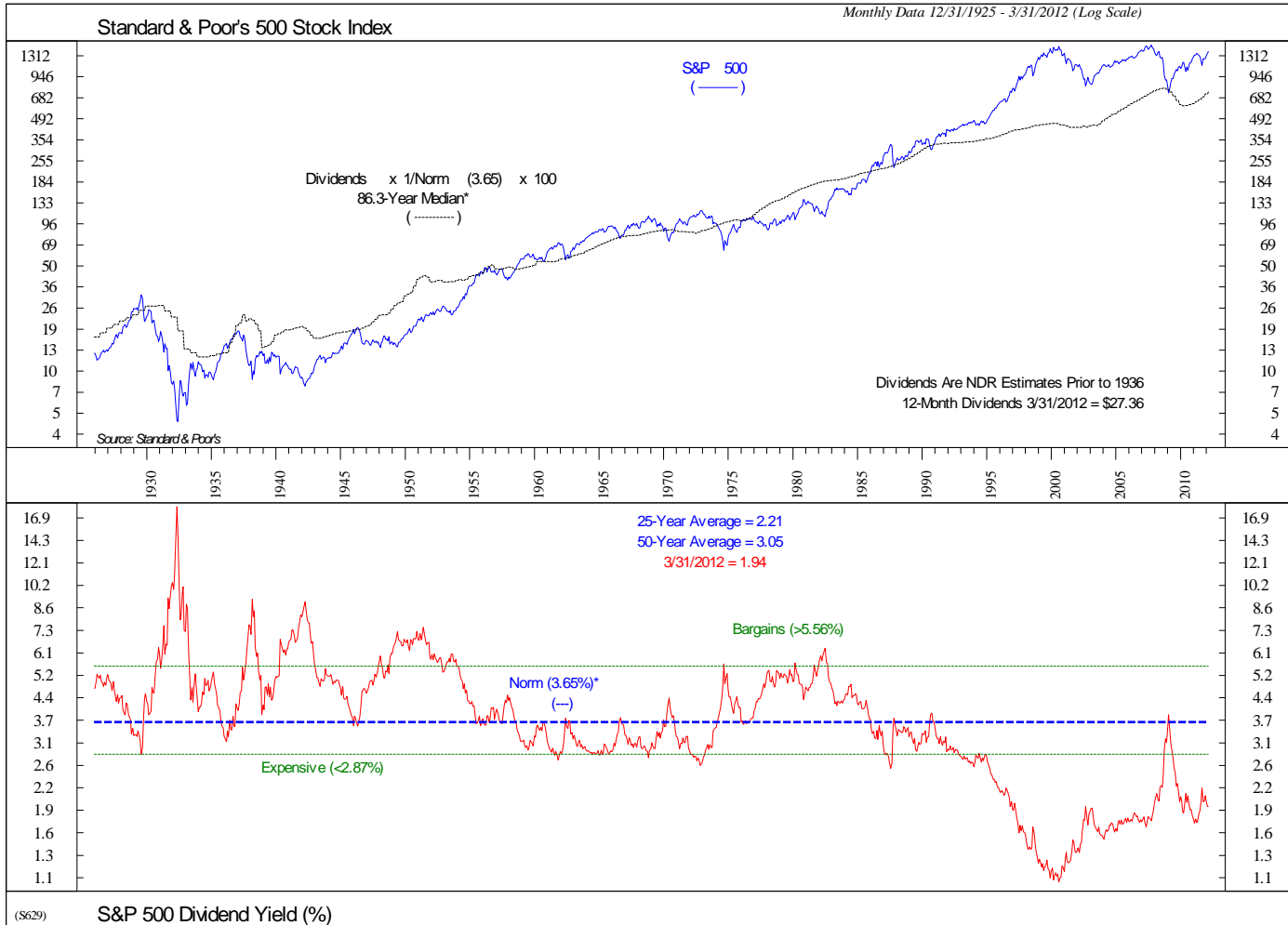
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- Earnings growth rates tend to be cyclical; earnings growth peaks have generally been associated with more challenging equity markets during the past 30 years



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- The stock market appears somewhat overvalued on measures such as price-to-book value...



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- ...and dividend yield.

Staying with “Quality”

- Investment-grade balance sheets (S&P senior debt ratings)
 - BBB- or better for all 32 companies
- Higher dividend yield
 - 2.85% vs. 2.46% for Russell 1000 Value vs. 2.03% for S&P 500

Insisting on “Cheapness”

- Weighted average FY2 P/E ratio of **11.5x** vs. 13.8x for Value Index
- 15 stocks with forward P/E ratios of 10x or below
- 16 stocks with price-to-book ratios below 2.0x

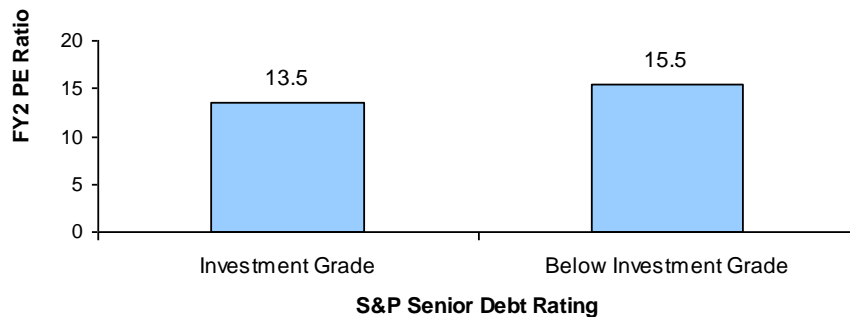
Focusing on Downside Risk

- Seeking stocks with less potential downside exposure
- Stressing our bear case analysis during fundamental research
- Weighing the trade-off between upside target price and downside risk price

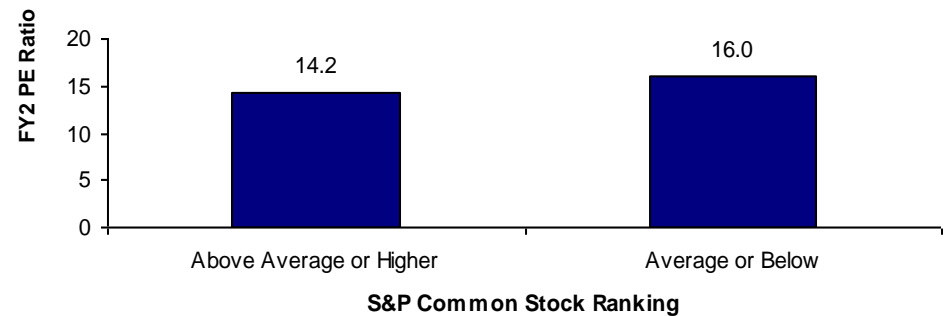
Seeing the Big Picture

- * **Credit Restraint**
- * **Higher Interest Rates**
- * **Commodities**
- * **Monetary Debasement**

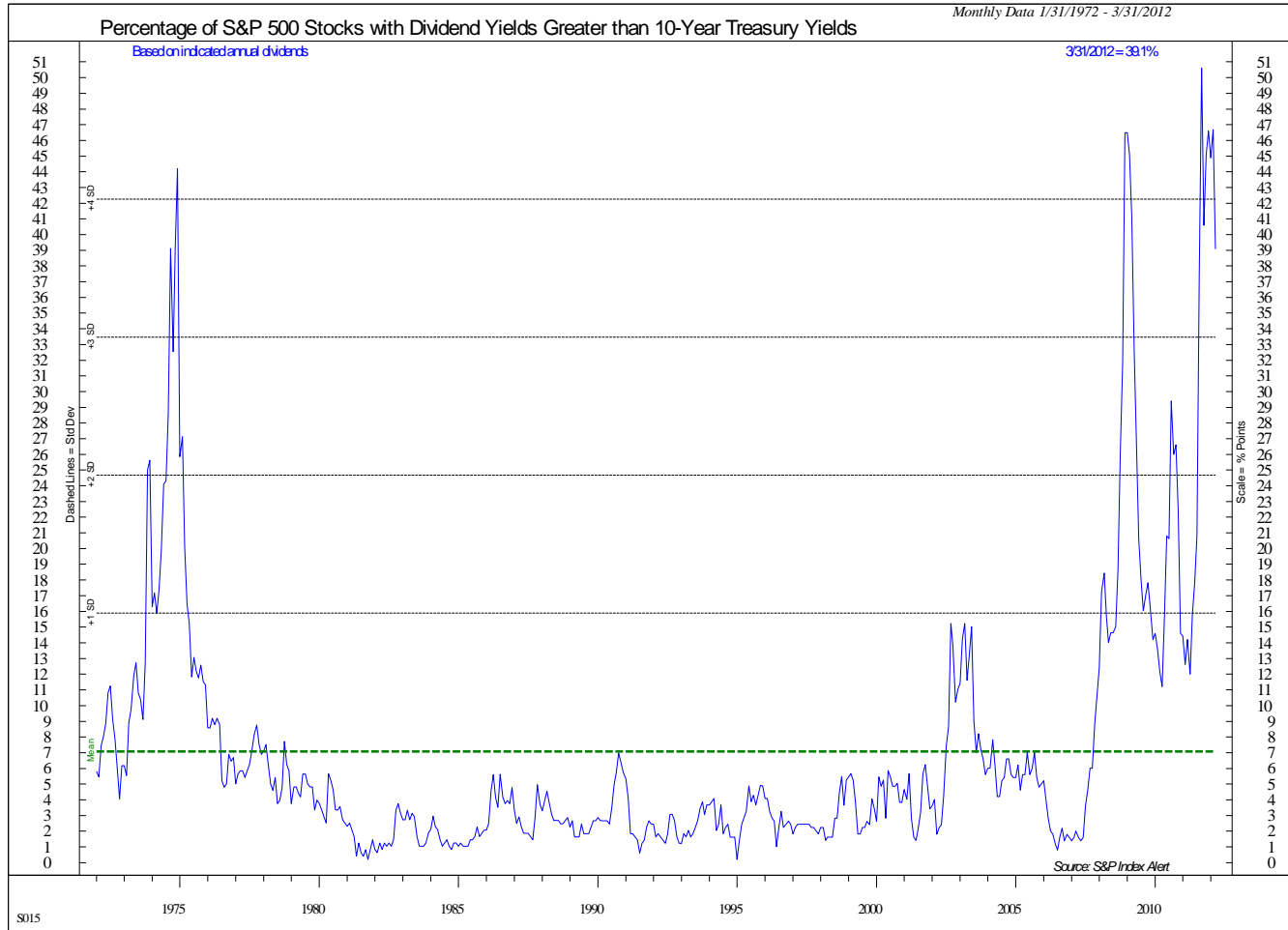
Debt Rating and Valuation
(S&P 500 companies as of 3/31/2012)



Stock Ranking and Valuation
(S&P 500 companies as of 3/31/2012)

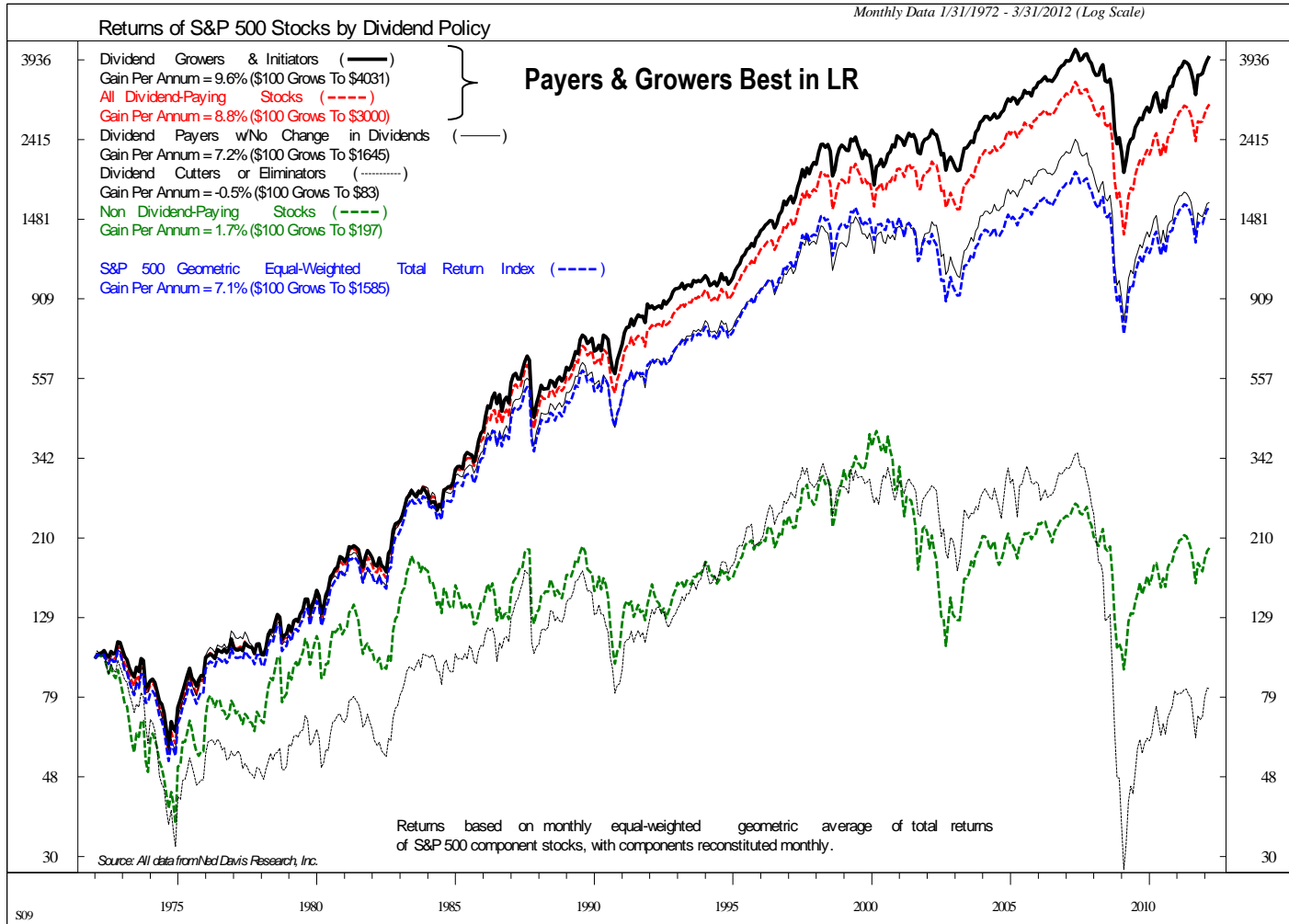


All Portfolio data as of 3/31/2012



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- The percentage of S&P 500 stocks with dividend yields > the 10-year treasury yield recently hit an all-time high and now stands at 39%
- As of 3/31/2012, 21 Delaware LCV portfolio stocks (66%) had dividend yields > the 10-year treasury yield



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- Returns of S&P 500 Index component stocks during the past 40 years based on dividend policy



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- Birthrates have generally had a positive correlation with stock prices when the birth cohort hits middle age