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# Strategic Insights

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## Long-Term Investment Outlook

In this quarter's edition of Strategic Insights, we update our long-term outlook for the major asset classes of stocks and bonds.

The experience of the so-called "lost decade" of the 2000s was in stark contrast to the robust equity market gains of the 1980s and 1990s, which rewarded buy-and-hold investors. Bond market investors, on the other hand, have enjoyed consistent, positive returns, benefitting from the steady decline in Treasury yields.

### Outlook Has Brightened for Long-Term Investors

The near-term uncertainty over the outcome of the European debt problem, and the fragile state of the U.S. economy, has kept investors scared and prompted them to sell their holdings of stocks. We can see this in the fastest pace of monthly money outflows from U.S. stock mutual funds since the panic selling during the peak of the financial crisis of 2008.

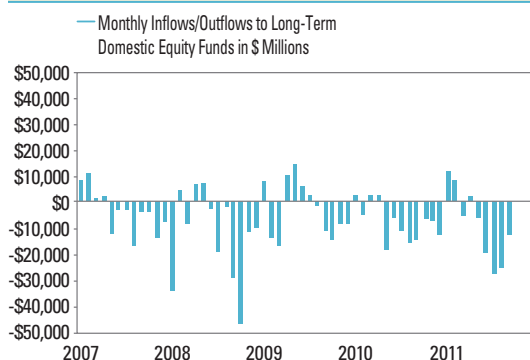
However, the long-term outlook is actually brightening for long-term investors. Many unique factors will influence stock valuations during the 2010s, including: the rise of the middle class in the emerging world; an aging population in the developed world; the end of the long decline in interest rates; unsustainable federal budget deficits in the United States; and evolving roles of government and business coupled with changing regulation in key industries such as energy, health care and finance, among others. Although we do not see a return to a 1990s-type of environment of powerful gains and soaring optimism, we disagree with the rampant pessimism surrounding the market outlook for the 2010s. We believe the next 10 years may likely be better for stock market investors than the losses suffered during the last decade.

We believe that history has made it clear that the most consistently accurate predictor of long-term stock market returns is the S&P 500 Index price-to-earnings ratio (P/E). The P/E is obtained by taking the price level of the Index and dividing it by the earnings per share over the past four quarters. Essentially, the P/E measures the number of dollars investors are currently willing to pay per dollar of earnings. It makes sense that the price you pay when you buy a stock can have a big impact on your return.

The current level of the P/E and the annualized return on stocks over the next 10 years have a very close relationship, as you can see in [Chart 2](#). In essence, the lower the P/E, the higher the return over the next 10 years. Currently, this relationship predicts that high single-digit gains are likely, on average per year, for the stock market over the next 10 years.

Despite the nearly perfect track record of the P/E in forecasting long-term performance, many investors have been selling recently and believe that it is different this time given the troubled banks, European credit problems, geopolitical tensions, concerns over both inflation and deflation, the U.S. budget deficit, threat of rising tax rates, and uneven economic data, among other concerns. We do not dismiss these issues. However, the P/E has

### 1 Monthly Inflows/Outflows to Long-Term Domestic Equity Funds in \$ Millions

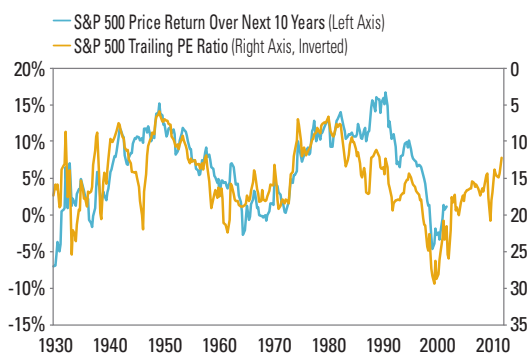


Source: LPL Financial, Investment Company Institute (ICI) 10/11/11

Investing in mutual funds involve risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

Past performance is no guarantee of future results.

### 2 80-year Long-Term History: P/E Predicts Gains for Stocks



Source: LPL Financial, Bloomberg, Thomson Financial 09/02/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.



Based on this relationship between future returns and P/E, the stock market's lowest valuations in 20 years suggests this is the best time in 20 years for long-term investors to consider buying, not selling, stocks.

demonstrated consistent success predicting long-term returns over the entire history of the S&P 500 Index—going all the way back to the 1930s.

Investors have always faced challenges. Since 1928, the S&P 500 Index has weathered massive bank failures, a dozen European countries defaulting, a world war, double-digit inflation, top marginal income and dividend tax rates of about 90 percent, the percentage of U.S. government debt-to-GDP at double the current level, not to mention the Great Depression. And yet, through all of these unprecedented events the P/E remained a consistently accurate forecaster of future long-term returns.

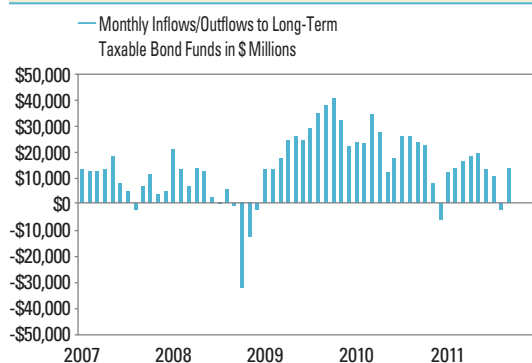
The annualized loss for stock market investors during decade of the 2000s was the result of the record high 30 P/E 10 years ago in early 2000. However, we believe the current P/E of about 12 forecasts a better decade for performance ahead. The current P/E of around 12 suggests a 7–8% price return for the S&P 500 Index, on average, over the next ten years. The addition of a 2% dividend yield may result in an annual average total return of 9–10%.

Based on this relationship between future returns and P/E, the stock market's lowest valuations in 20 years suggests this is the best time in 20 years for long-term investors to consider buying, not selling, stocks.

Often, investing can be emotional, and the near-term clouds of uncertainty too often obscure what we may feel more certain of over the long term. This simple predictive relationship between P/E and future returns gives us hope that it is not different this time. It is easy to focus on all that could go wrong and assume it is insurmountable, but history shows us that what really matters is the price we pay and not so much what happens along the way.

Over the longer term, we believe returns will be below the average of the 1980s and 1990s, but we do not anticipate negative returns like those experienced in the 2000s. Over the history of the S&P 500 Index, going all the way back to the 1920s, the Index has produced an annualized total return of 8.1% (as of 12/31/2010). We believe that stocks may post an average annual total return similar to this long-term average during the 2010s, supported by earnings growth in the mid-single digits and a dividend yield of 2–3%.

### 3 Monthly Inflows/Outflows to Long-Term Taxable Bond Funds in \$ Millions



Source: LPL Financial, Investment Company Institute (ICI) 10/11/11

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### Dim Prospects for High-Quality Bonds

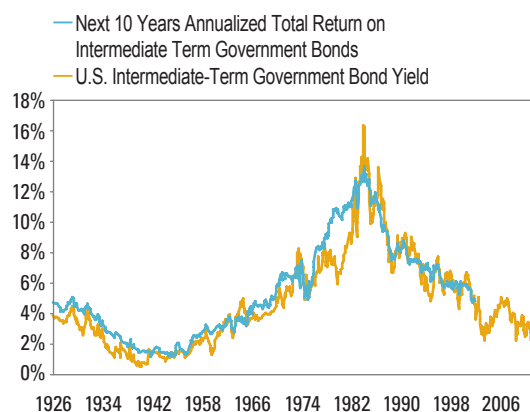
While investors have been selling their holdings of stocks, they have been buying bonds, as we can see in [Chart 3](#). As investors shun the short-term volatility of stocks and seek the consistent returns of the bond market they may be overlooking the long-term negative facing the bond market.

Similar to the predictive power of P/E ratios for future stock market performance, interest rates have historically framed future return expectations for bond market investors. The yield on an intermediate-term government bond index (Ibbotson U.S. Intermediate-Term Government Bond Index) has proven a reliable indicator of its performance over the next ten years—even during volatile periods for interest rates. Given the current low level of interest rates, the total return for the bond market over the next ten years is likely to be in the low-single digits, marking a big change in



Based on this relationship between future returns and high-quality bond yields, the bond market's lowest yields in 50 years suggests this is the best time in 50 years for long-term investors to consider selling, not buying, high-quality bonds.

#### 4 Yield Matters: Yield Forecasts Total Return for Bonds



Source: LPL Financial, Ibbotson Associates, Barclays, Bloomberg

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

Long-term investing strategies may also be found by avoiding the temptation to follow the herd when at extremes.

performance for bonds. Investors expecting similar performance to the bond market bull-run of the 1980's, '90s and '00s ought to brace themselves for the potential for a low return environment for bonds.

The relationship between yields and returns is shown for intermediate-term government bonds, given the long history of the index, as you can see in [Chart 4](#). But the relationship has also held true more recently for other fixed income asset classes. The relationship has held during periods of deflation, inflation, rising yields, falling yields, recessions and financial crises.

Based on this relationship between future returns and high-quality bond yields, the bond market's lowest yields in 50 years suggests this is the best time in 50 years for long-term investors to consider selling, not buying, high-quality bonds.

Bond market investors who benefitted from the persistent decline in interest rates over the course of the last three decades should temper their return expectations going forward. The low index yield represents a slim income buffer as protection against rising interest rates. Since its inception in 1976, the Barclays Aggregate Bond Index has suffered just two negative return years, 1994 (-2.9%) and 1999 (-0.8%), both of which coincided with the start of Federal Reserve rate hike cycles. While the Fed has pledged to maintain low interest rates until mid-2013, easy monetary policy will not last forever. At some point this decade, likely to coincide with declining unemployment and increasing inflation expectations, the Fed will shift to tighter monetary policy and hike rates. We expect core bond returns, measured by the Barclays Aggregate Bond Index, to average in line with the current yield on that index.

### Long-Term Investment Strategies

Sometimes, long-term investment strategies can be a function of being contrarian and moving against the crowd when sentiment is at extremes, as it appears to be today. Long-term investing strategies may also be found by avoiding the temptation to follow the herd when at extremes.

Recent lackluster global economic data, challenging financial conditions and volatile market performance reflect some of the headwinds facing investors in the near-term. The decade of the 2000s, still fresh on their minds, shook the confidence of many investors. Long-term goals can still be achieved, however, by planning realistically and focusing on key drivers of returns, namely valuations. For equity market investors, valuations are at their most attractive levels in more than twenty years, a defining characteristic that may lead to the best of times for this decade. High-grade bond market participants, on the other hand, may need to take a more subdued view as record-low yields suggest a low return environment and offer little protection against eventual increases in interest rates.



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#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of \$11.18 trillion and serve nearly 90 million shareholders.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

The Ibbotson U.S. Intermediate-Term Government Bond Index is measured using a one-bond portfolio with a maturity near five years.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

This Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

Stock investing may involve risk including loss of principal.



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