



REFLECTIONS ON A NEW RECORD

Several months ago, the Dow Jones Industrial Average passed a milestone, more notable than important, by establishing a new record high for the first time in nearly seven years. On October 3, 2006, the Dow closed at 11,727.34, surpassing the previous high close of 11,722.98, set on January 14, 2000. Later that week, on October 6, the Dow reached an intra-day high of 11,921.04, surpassing the previous intra-day high of 11,908.50, also set January 14, 2000. In spite of the excitement with which the financial press greeted the new record, market professionals, recognizing just how narrow an index the Dow really is (it only comprises 30 stocks, after all), mostly preferred to focus on the broader market.

Today, May 30, 2007, the Standard and Poors 500 Index, one of the leading measures of the broad market, finally achieved a record high close of its own. The S&P 500 closed at 1530.23, surpassing its previous high close of 1527.46, on March 24, 2000. It has yet to match the intra-day high of 1552.87, reached that same day. The fun officially begins this afternoon, as bulls tout a new, powerful leg upward and bears lament what they will claim is an excessively frothy market.

LESS THERE THAN MEETS THE EYE

Market records make good copy for journalists, but when they come after a lag of more than seven years, they don't shine so brightly. The S&P closed today just above its level of March 24, 2000. That means that over the past 86 months, the price change of the index has been — nothing! The total return, including dividends, is a cumulative +12.75% or so, an annualized figure of +1.63%.¹ This is the worst performance since the deep bear market of the 1970s.² So while the market could certainly turn downward from here, it's hard to sustain the case that the new record is evidence of froth in the market.

The naysayers do have a point or two, however, that command our attention. For one, they will generally point to valuations. In particular, the price-earnings ratio of the S&P 500, they will argue, is still relatively high by historical standards. Now, during the seven years or so

¹ The historical data for the Dow and the S&P are from Yahoo! Finance. I've estimated the total return on the S&P 500 from historical data I have collected over time from S&P, but it's really my estimate.

² Specifically (my calculation based on monthly data; data prior to 1973 from Ibbotson and Sinquefeld, "Stocks, Bonds, Bills, and Inflation," *Journal of Business* **49**, 11-47 (1976); later data from S&P), large-cap US stocks returned an annualized -2.64% for the seven years ending September 1974.

during which the S&P has made nothing more than a round trip to 2000 levels, corporate earnings have been increasing steadily. As a result, S&P's estimate of the price-earnings (PE) ratio of the index has fallen from 29.41 in the first quarter of 2000 to an estimated 18.16 in the first quarter of 2007. But bears will argue that this figure in the high teens may still be high. After all, in the fourth quarter of 1972, on the eve of a punishing two-year bear market, the figure stood at 18.39, just before falling as low as 6.97 in the third quarter of 1974.³

So while the PE ratio of the S&P 500 is much lower than it was seven years ago, it remains at levels from which the market has fallen sharply in the past. On the other hand, the PE of the S&P 500 remained at 15 or more for the entire decade of the 1990s. In the end, the valuation argument merits watching, but doesn't portend disaster on its own.

THE PRIVATE EQUITY EFFECT

Another type of PE — private equity — also bears watching in connection with the strength of the market. As in the mid-1980s, the past couple of years have seen an elevated, and accelerating, pace of merger and leveraged buyout activity. One of last week's announcements gives an indication:

A pair of investment firms have agreed to acquire Alltel Corp., the fifth-biggest U.S. wireless company and owner of the nation's largest geographic network, in a deal worth \$24.8 billion. ...

The agreement calls for the two investment firms to acquire all of the outstanding common stock of Alltel for \$71.50 per share in cash. According to Alltel, that represents a 23 percent premium over Alltel's share price before word of a possible buyout first appeared in the media on Dec. 29.⁴

The Alltel deal illustrates both the possible size of deals in the current market, and the high purchase prices that many deals command. Of course, a high purchase price is only good for the party on one side of the deal, as another example illustrates:

Microsoft Corp. on Friday agreed to pay \$6 billion in cash for Internet marketing firm aQuantive, extending the software giant's reach into online advertising and giving it more ammunition in its fight with Google Inc.

³ Source: Standard & Poors, here: <http://www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS> and http://www2.standardandpoors.com/spf/xls/index/sp500pe_ratio.xls

⁴ Tom Parsons, "Alltel Agrees to \$24.8 Billion Buyout," Associated Press, May 21, 2007 at http://biz.yahoo.com/ap/070521/alltel_buyout.html?v=18

The deal is Microsoft's largest acquisition ever in its 32-year history and the biggest by far in this recent run on Internet advertising technology companies.

The transaction values shares of aQuantive, which has roughly 2,600 employees, at \$66.50 each - a huge 85% premium compared to the company's closing price on Thursday of \$35.87.

aQuantive's stock jumped \$27.92 a share, or almost 78%, to close at \$63.79, while Microsoft fell 15 cents to close at \$30.83.⁵

Let's focus on the purchase price — an 85% premium over aQuantive's pre-announcement level, according to the article. Of the \$6 billion Microsoft seems ready to pay, about \$2.75 billion represents purchase premium, and aQuantive's stock rose accordingly. On Friday, May 18, the day of the announcement, Microsoft's stock fell by 15 cents, or around -0.5%, while the S&P 500 rose by about +0.66%. So on May 18, Microsoft under-performed the market by around 1%, or 30 cents per share. With about 10 billion shares outstanding, Microsoft's under-performance came to around \$3 billion, close to the purchase premium on the deal. The calculation suggests that the market's assessment of the deal is that it creates no value. Rather, the stock market simply looked at the \$2.75 billion purchase premium, and transferred about that amount from Microsoft's shareholders to aQuantive's.

When one public company buys another, the result is often just a transfer from one firm's shareholders — usually the buyer's — to another's. By contrast, when private equity investors overpay for public companies, the resulting transfer of value is a net increase in the wealth of public market shareholders. Many shareholders reinvest the proceeds of these sales, providing a general lift to the market. So as long as private equity investors maintain their ravenous appetite for deals, the effect on the public market is likely to be beneficial.

WHAT SHOULD WE BE WATCHING?

What could bring the current private equity wave to a halt? For a hint, let's look at the mid-1980s, the last time we saw such a surge in leveraged buyout activity.⁶ From 1982 to 1986, the S&P 500 produced strong returns, returning an annualized +19.9% for the five years. Leveraged buyout activity boomed, famously supported by ample bank lending and junk bond financing (bought in large quantities by Savings and Loan institutions, to the later grief of many), largely underwritten by Michael Milken's group at Drexel Burnham Lambert. But in 1987, interest rates spiked, with the yield on the 10-year US Treasury note jumping from 7.25% in

⁵ MarketWatch, "Microsoft Snaps Up aQuantive for \$6 billion," May 18, 2007. At <http://www.marketwatch.com/news/story/microsoft-acquire-aquantive-6-blm/story.aspx>

⁶ I'm using the terms *private equity* and *leveraged buyout* interchangeably, and on purpose. In fact, private equity investors support a variety of types of deals, but the type of deal that figures most prominently in the effects I'm discussing here is essentially the same as the leveraged buyouts that were so big in the 1980s.

March 1987 to 8.61% in May. Rates kept moving up, and by October, the 10-year yield was 9.52%.⁷ That October, the US stock market fell more than -20% in a single day, resulting in a one-month S&P 500 return for October 1987 of -21.5%. (The full-year return was nevertheless positive, at +5.3%). The upward march stalled for a time, and the 1988 buyout of RJR Nabisco proved really to be the capstone to that era of leveraged buyouts.

The concern here is that the public market is receiving at least part of its support from private equity buyers, and that private equity deals receive their support, at least in part, from ample, cheap liquidity. Low interest rates (the 10-year Treasury yield now, May 30, 2007, stands at 4.88%) are one factor, but so are the large amount of cash in private equity funds, and the appetite of hedge funds and large banks for lending against private equity deals. Interestingly, the official position of private equity professionals seems to be different:

Cheap debt is not the principal driver of the private equity buyout boom. According to a survey by Mergermarket and the law firm Fried, Frank Harris, Shriver & Jacobson, only 3% of p.e. pros, M&A bankers and corporate CEOs pin the boom primarily on the cheap debt; more credit goes to the popularity of consortium bids and the fact that larger companies are more likely to produce superior returns compared with smaller ones. As a result, the survey found, mega-buyout activity is likely to remain robust this year regardless of changes in the credit cycle.⁸

If the poll is correct, then it isn't cheap debt, but cheap equity that's driving the buyout boom. I say that because an increase in "consortium bids" — buyout deals involving groups of firms, rather than a single private equity firm — and a preference for buying larger companies both indicate that private equity firms have a great deal of capital to deploy. With so much capital, private equity firms inevitably must accept lower returns on their deals, especially as the market becomes more competitive (though the consortium deals reflect sort of a buyers' cartel effect, reducing competition). But investors continue to commit capital, suggesting that they are content with, or at least reconciled to, relatively low returns on their private equity investments — that is, they provide cheap equity.

Debt or equity, cheap capital relies on ample liquidity, meaning a lot of money is chasing the available deals. Market liquidity is a fair-weather friend of investment returns. Accordingly, I've generally been watching for early signs of trouble in the private equity landscape. So far, so good, but let a leveraged deal or two go sour in a big way, and the landscape could shift quickly.

⁷ Source for interest rates: The immensely useful FRED database from the St. Louis Fed, at <http://research.stlouisfed.org/fred2/series/GS10?&cid=115>

⁸ Hedge Fund Daily, "Poll: Cheap Debt Not Driving Buyout Boom," May 21, 2007, at <http://www.dailyii.com/article.asp?ArticleID=1357618&LS=EMS128263>

Similarly, if interest rates should spike sharply upward, as they did in 1987, that sharp rise in the cost of capital could once again hit the equity markets pretty hard.

CONCLUSION: CAUTIOUS OPTIMISM

On balance, the general tone of the market is good. We have seen earnings growing solidly, strong interest on the part of potential acquirers fueling acquisition activity and giving a general boost to prices, and interest rates remaining reasonably low. Enough investors and analysts maintain cautious tones to suggest that the balance between buyers and sellers is also reasonably good.

The record the market has just set brings the total return on the broad market (as represented by the S&P 500) up to an anemic +1.63% annualized over the past seven years, which, along with the other factors I've cited, hardly seems like a sign of an overheated market. On the other hand, valuations (or price-earnings ratios, anyway) seem a bit high, and private equity activity, along with its cousin, low interest rates, seems to be providing a prop to the market. So while I remain optimistic, it's a cautious optimism. Equity markets seem to be at about their normal balance of opportunity and risk, so in my view portfolios ought to remain near their normal balance as well.

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