

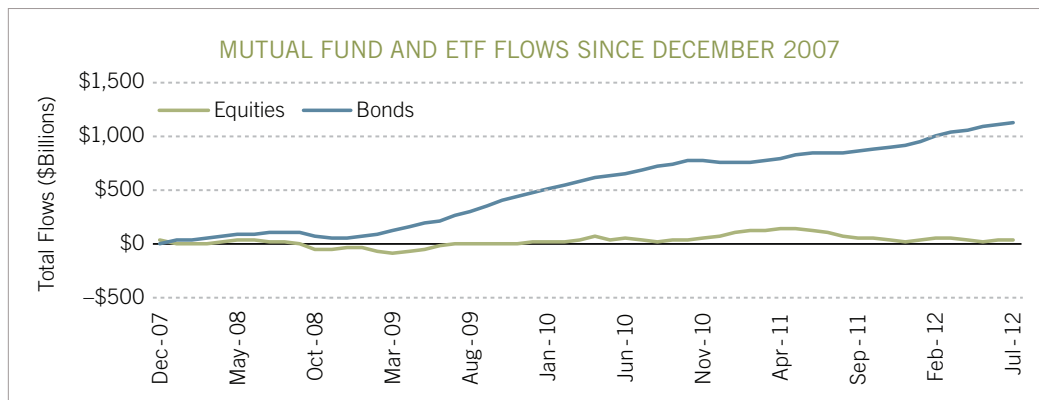
# U.S. Equities: Light at the End of the Tunnel

By the end of 1999, U.S. equities and investment-grade bonds had both enjoyed a nearly two-decade-long bull market, precipitated in large part by steady declines in interest rates and inflation that boosted the prices of financial assets. Since then, their paths have diverged. Interest rates have fallen to near-historical lows, extending the bond bull market to more than 30 years, while equities have stalled. From 2000 to 2012, bonds provided a 3.9% inflation-adjusted (real) return, compared to a -1.1% real return for equities. By contrast, during the past 30 years the relative returns for both asset classes have been quite different, with equities producing an 8.1% real return and bonds generating a 6.1% real return.<sup>1</sup>

The below-average real returns for equities during the past 12 years, in combination with the near-uninterrupted 30-year rally for bonds, has led to a recent shift in investor preferences. Since December 2007, investors have poured more than \$1.1 trillion into bond mutual funds and exchange-traded funds (ETFs)—more than 33 times the amount allocated to equity funds and ETFs (see Exhibit 1, below). Many institutions also have reduced long equity allocations. This behavior illustrates how some investors—in an increasingly uncertain world—may have begun to question the value of maintaining an exposure to equities.

History suggests that the combination of a sustained performance gap and a prolonged shift in investor preferences can lead to over- (or under-) exuberance and relative valuation discrepancies that may provide important signals for a shift in intermediate-term investment performance. The following article investigates the outlook for U.S. equities, and evaluates whether the growth, inflation-fighting, and portfolio diversification characteristics of the asset category are likely to continue helping investors meet their objectives over an extended time horizon.

**EXHIBIT 1:** Since December 2007, investors have favored fixed-income securities, plowing over \$1.1 trillion into bond mutual funds and ETFs while equity funds received around \$33 billion.



Source: Investment Company Institute, Haver Analytics, Fidelity Investments (AART) through Jul. 31, 2012.

Dirk Hofschire, CFA  
SVP, Asset Allocation Research

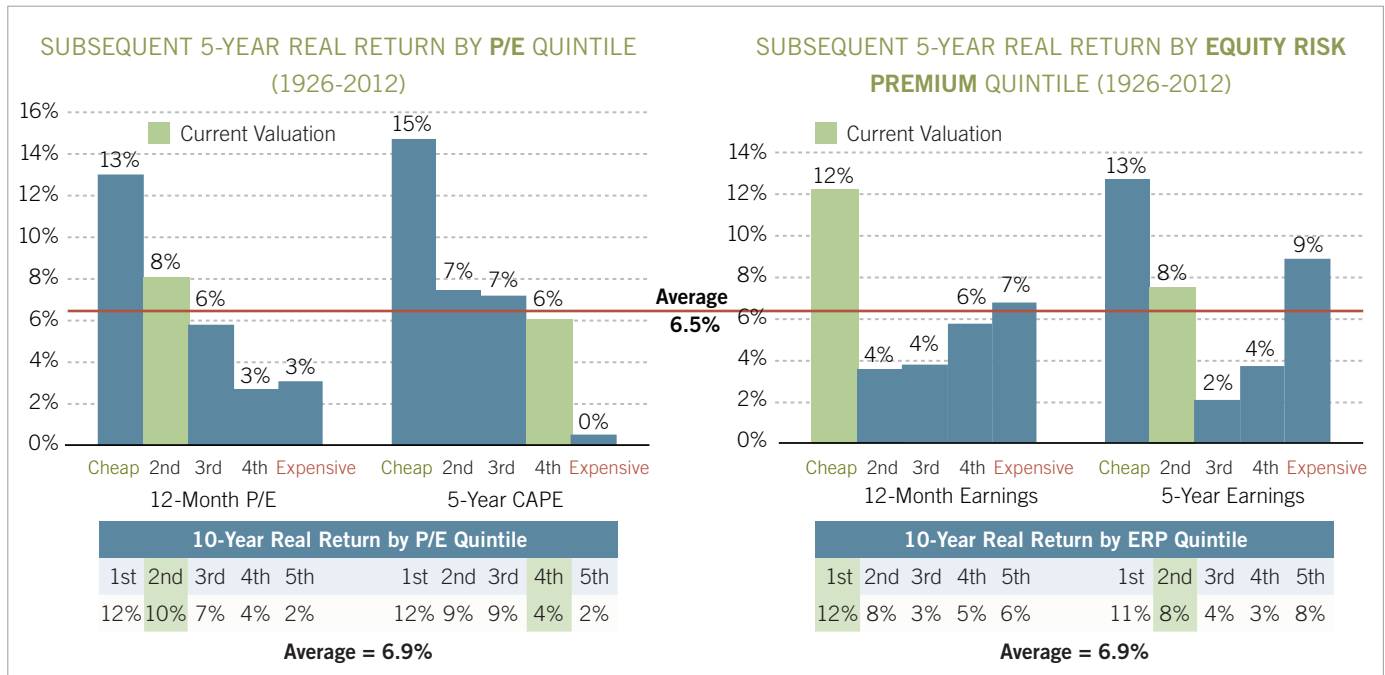
Lisa Emsbo-Mattingly  
Director of Asset Allocation Research

## KEY TAKEAWAYS

- A 12-year period of poor real returns has helped shift investor preferences away from U.S. equities; however, on an intermediate-term basis, it may be an inopportune time to be underexposed to this asset class.
- Equities can play a strategic role in long-term wealth creation and portfolio diversification, given historically low correlations with bonds and better potential to achieve positive real returns amid rising inflation.
- Many indicators suggest equities have valuations which historically preceded higher-than-average absolute and relative returns over the intermediate term.
- Although U.S. fiscal challenges threaten the economic outlook, we believe progress on the medium-term sustainability of the U.S. fiscal situation could help reduce the uncertainty that has weighed on equity markets.
- We do not expect the real returns of U.S. equities to be dramatically below their long-term averages over the next five to 10 years, and believe that the U.S. equity market will provide a rich hunting ground for active investors.



EXHIBIT 2: Most valuation metrics suggest U.S. equities are inexpensive, which has historically resulted in above-average returns.



Stocks represented by total returns of the S&P 500 Index, which includes reinvestment of dividends and interest income. Equity risk premium is the difference between the S&P 500 earnings yield (inverse of P/E) and the 10-year Treasury bond yield. Source: Standard & Poor's, Robert Shiller, Fidelity Investments (AART) through Jul. 31, 2012. Past performance is no guarantee of future results.

### What valuations imply about future equity returns

Valuation analysis historically has been a useful indicator of future performance, but its reliability has tended to be significant only over intermediate- or long-term time horizons. We focus our analysis on valuation metrics that in the past have provided important clues about the returns to equities over subsequent five- and 10-year periods. Because valuation metrics can vary based on various measures of corporate earnings, different time periods have been incorporated into the analysis, using earnings data since 1926.

#### Absolute returns

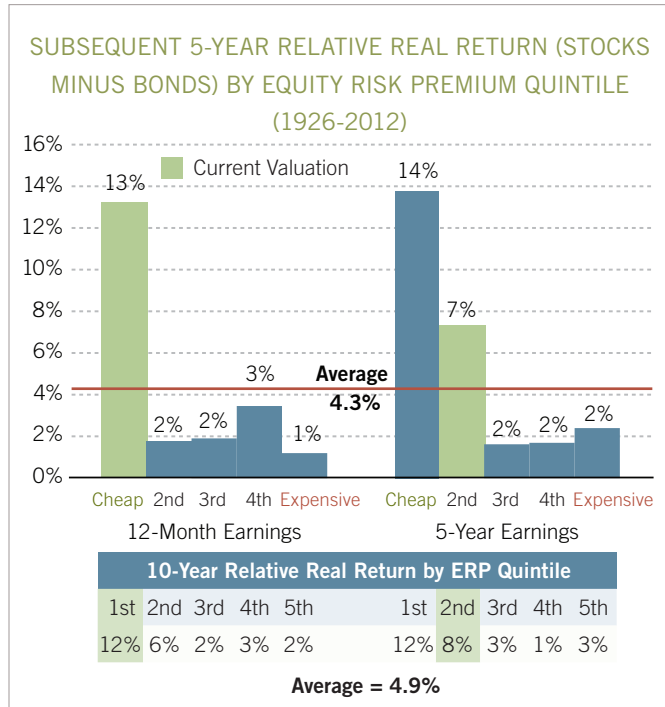
The current price-to-earnings (P/E) ratio, using the trailing one-year earnings of the S&P 500 Index, stood at 13.8 at the end of the second quarter of 2012. This level places the ratio in the second least-expensive quintile of all quarterly valuations for the market since 1926 (see green shaded areas in Exhibit 2, above left). Historically, owning the equity market at these inexpensive valuation levels has produced above-average subsequent intermediate- and long-term real returns to equities (8.1% on a five-year annualized basis and 10.1% on a 10-year basis, significantly above the 6.5% and 6.9% historical averages, respectively—Exhibit 2). Using consensus estimates of earnings over the next 12 months, the forward P/E of the market is even lower at 12.5, but limited historical data make this measure difficult to compare to previous periods.<sup>2</sup>

Cyclically adjusted P/E ratios (CAPEs)<sup>3</sup> utilize an entire cycle of earnings to smooth out near-term fluctuations, with the theory being that one-year trailing earnings reflect short-term cyclical forces and may not represent a sustainable earnings level. While the 10-year CAPE is often used, we prefer the five-year CAPE since our definition of a full business cycle has averaged roughly five years since 1950. Looking at P/E ratios on both a five- and 10-year CAPE basis, the equity market's current valuation is somewhat expensive—both measures fall in the second most-expensive quintile of observations since 1926 (see green shaded areas in Exhibit 2, left). The subsequent returns to this more expensive quintile have been lower than the overall market average on both a five-year and a 10-year basis.

Equity valuations also may be measured by comparing the earnings yield (the inverse of the P/E) to the level of bond yields, which results in a simple calculation of the equity risk premium (ERP = earnings yield minus 10-year Treasury bond yield). When the ERP has been high historically (stocks inexpensive), subsequent five- and 10-year equity returns have been well above their historical averages (see green shaded areas in Exhibit 2, right). The equity market's current ERP is high (stocks inexpensive) no matter how the earnings are calculated, which in the past has preceded above-average absolute returns.

In summary, different valuation metrics offer different conclusions about the outlook for U.S. equities. However, many valuation

**EXHIBIT 3: Current equity risk premium levels suggest U.S. equities are historically inexpensive, and in the past have preceded above-average returns relative to bonds.**



% = percentage points of relative real return. Stocks represented by total returns of the S&P 500 Index, which includes reinvestment of dividends and interest income. Bonds represented by the Barclays Aggregate Bond Index from January 1976 through July 2012 and by a composite of the IA SBB I Intermediate-Term Government Bond Index (67%) and the IA SBB I Long-Term Corporate Bond Index (33%) from January 1926 through December 1975. Equity risk premium is the difference between the S&P 500 earnings yield and the 10-year Treasury bond yield. Source: Standard & Poor's, Robert Shiller, Fidelity Investments (AART) through Jul. 31, 2012. Past performance is no guarantee of future results.

indicators suggest equities are inexpensive, and historically that has led to a higher-than-average return over intermediate- and longer-term time frames.

### Relative returns

As described above, the ERP is the most common metric to compare valuations between equities and high-quality bonds, and the ERP is currently at high historical levels. At these elevated levels, equities historically have had far-above-average five- and 10-year subsequent real returns relative to bonds. For instance, using one-year trailing earnings, stocks at current ERP levels averaged 13.2 and 12.0 percentage points of outperformance, respectively, relative to bonds on a five- and 10-year basis, compared to 4.3 and 4.9 percentage points on average (see Exhibit 3, above).

In today's environment, some investors may question whether extraordinary circumstances have depressed bond yields to

such low levels that the resulting high ERP may not be predictive of strong future performance of equities. For instance, one argument is that the Federal Reserve (Fed) is implementing an unprecedented unconventional monetary policy, leading to a form of financial repression that anchors bond yields lower. However, when we analyze the last major period of financial repression, from 1942 to 1951—when the Fed pegged Treasury bond yields to help finance World War II—there exists a similar pattern to today, where real bond yields are negative, P/E multiples are low, and the equity risk premium is high (see Exhibit 4, below). Similar to the results seen from 1926 to 2012, equities achieved higher subsequent five- and 10-year returns on both an absolute and a relative basis when they started from low valuations (high ERPs and low P/Es).

Another consideration is whether low bond yields are a signal of continued deflationary pressures, in which case prolonged economic stagnation may be a headwind for stock returns despite the high ERP levels today. However, during the period of prolonged U.S. deflation in the 1930s, the relationship between lower P/Es and high ERPs signaling above-average five- and 10-year equity real returns generally held. For example, valuations within the cheapest two quintiles by equity risk premium during the 1930s resulted in above-average returns on both an absolute and a relative basis over the subsequent five- and 10-year periods.<sup>4</sup> Elsewhere, during 1989 in Japan, the stock market bubble burst with deflation setting in by the mid-1990s. However, Japan's ERP did not turn sustainably positive until the early 2000s, implying stocks never became cheap on an ERP basis during Japan's post-crisis deflationary malaise, which offers little similarity to today's favorable valuation backdrop in the U.S.<sup>5</sup>

**EXHIBIT 4: During the period of financial repression from 1942 to 1951 when bond yields were low, U.S. equities achieved higher returns on an absolute basis and relative to bonds.**

Historical Example of Financial Repression		
Average 1942-1951		
10-Year U.S. Treasury Bond Real Yield	-3.5%	
Equity P/E Ratio	10.7x	
Equity Risk Premium	8.0%	
Forward Return*	5-Year Real Equity Return	11.3%
	10-Year Real Equity Return	13.6%
	5-Year Relative Real Return (Stocks-Bonds)	14.5%
	10-Year Relative Real Return (Stocks-Bonds)	15.5%

\* Forward returns: the average of the subsequent five- and 10-year annualized returns for the months between March 1942 and March 1951. Stocks represented by total returns of the S&P 500 Index, which includes reinvestment of dividends and interest income. Bonds represented by a composite of the IA SBB I Intermediate-Term Government Bond Index (67%) and the IA SBB I Long-Term Corporate Bond Index (33%) from 1942 to 1951. Equity risk premium is the difference between the S&P 500 earnings yield and the 10-year Treasury bond yield. Source: Morningstar EnCorr, Robert Shiller, Standard & Poor's, Fidelity Investments (AART) through Dec. 31, 1951. Past performance is no guarantee of future results.

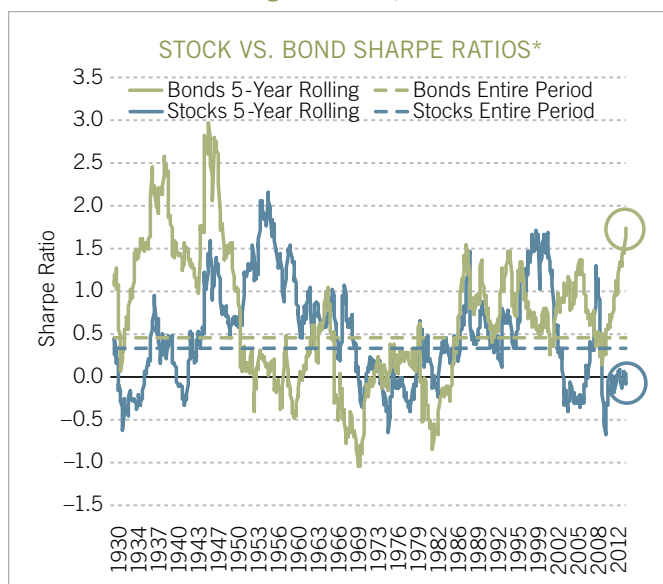
In summary, current valuation levels have historically resulted in significant subsequent intermediate-term outperformance of equities relative to bonds, even during periods when high ERPs were boosted by financial repression or deflationary expectations.

### Assessing the strategic role of equities in a portfolio

At their essence, equities have several underlying characteristics that define their risk/return profile as investments. Equities represent ownership, which involves higher levels of both potential risk and reward relative to debt and other capital instruments. Thus, equity represents a claim on a company's future earnings, so both in theory and practice equity prices have been closely tied to corporate profitability (equity prices have risen at a 2.4% inflation-adjusted annualized rate since 1926, in line with a 2.1% increase in inflation-adjusted earnings).<sup>5</sup>

Historically, performance patterns have been consistent with these characteristics, as equities on average have exhibited both higher volatility and higher returns than bonds. The real total return (with dividends reinvested) to equities averaged 6.6% versus 2.5% for high-quality bonds since 1926, while the performance volatility of equities also has been far higher (19% standard deviation relative to 4% for bonds).<sup>6</sup> As a result, stocks have been critical as a source of long-term wealth creation.

**EXHIBIT 5: Stock and bond Sharpe ratios have tended to mean revert over time; currently the rolling five-year Sharpe ratios show stocks are below their long-term trend, while bonds are far above.**



\*Sharpe ratio: a measure of the mean return per unit of risk in an investment asset or a trading strategy. Stocks represented by the S&P 500 Index. Bonds represented by the Barclays Aggregate Bond Index from January 1976 through July 2012 and by a composite of the IA SBB Intermediate-Term Government Bond Index (67%) and the IA SBB Long-Term Corporate Bond Index (33%) from January 1926 through December 1975. Source: Morningstar EnCorr, Fidelity Investments (AART) through Jul. 31, 2012. Past performance is no guarantee of future results.

### Risk-adjusted performance

According to modern portfolio theory, the extra return generated by riskier equities should, over time, compensate for the added volatility that an investor accepts. If one asset continuously offers better risk-adjusted performance, investors should eventually gravitate toward that asset and push up its relative valuation until the risk-adjusted return expectation diminishes. In practice, equities (0.33) and bonds (0.46) have had a similar long-term Sharpe ratio\* since 1926 and the risk-adjusted performance of equities and bonds has tended to mean revert over long periods of time.

During the past five years, bonds have had a far-above-average Sharpe ratio (1.72) while equities have had a far-below-average one (0.02) (see Exhibit 5, below left). As bond returns have outpaced stocks over the past five- and 10-year periods, investors have not needed to add the extra volatility of stocks to their portfolios to achieve strong performance. However, historically, such large trailing Sharpe-ratio discrepancies have typically resulted in significant improvement in the risk-adjusted returns of equities relative to bonds over subsequent five- and 10-year time periods.

### Low correlation with bonds

The different risk/return characteristics of equities, particularly their generally positive sensitivity to changes in the economic and corporate backdrop, provide the basis for their historically low performance correlations with high-quality bonds. Since 1926, the correlation between U.S. equities and bonds over the long term has been 0.2, and despite the rise in correlations among many assets during the past decade, equity/bond correlations have been near zero.<sup>7</sup> These characteristics and low correlations can provide important diversification benefits to a portfolio.

### Better able to weather inflation

In theory, equity prices are bound to the discounted future stream of a company's profits, while bond prices reflect discounted fixed future cash payments. During an environment of higher-than-expected inflation, fixed-rate bond payments would remain constant, but because a company may have the ability to upwardly adjust its pricing, its nominal profits might adjust upward as inflation rises. Equities therefore should provide the potential for a greater upward adjustment with inflation compared to fixed-rate bonds.

In practice, equities have generally maintained an advantage over bonds during periods of higher inflation. From 1970 to 1980, inflation averaged 7.8% annually, more than double its historical average. During this period, high-quality bonds returned 6.6%, resulting in a -1.1% real return; equities returned 8.0%, and had a 0.2% real return (see Exhibit 6, page 5).<sup>8</sup> Despite three economic recessions that took place from 1970 to 1980, nominal profit growth was well above average at 9% per year, showing the ability of nominal earnings to adjust upward with inflationary pressures.<sup>9</sup>

### Considerations in today's low-yield environment

The most indisputable characteristic of today's environment is the low level of bond yields. The last time bond yields were nearly this low was in 1952, when 10-year Treasury yields were 2.7% (versus 1.7% today).<sup>10</sup> From 1952 to 1964, bond yields rose gradually up to 4.2%, while inflation remained low (1.4% annual rate versus 3% long-term average). During this period, bond performance volatility was muted, but the real return to bonds was a subpar 1.6% (versus 2.5% long-term average), and the Sharpe ratio was 0.2 (see Exhibit 6, below). Equities, on the other hand, generated above-average real returns (13.2%), below-average volatility, and above-average Sharpe ratios.

During the subsequent period from 1965 through 1969, inflation rose to 5.9% and 10-year bond yields climbed to 7.7%. Bond volatility rose, while real and risk-adjusted bond returns turned negative (Exhibit 6). Real and risk-adjusted returns to equities also deteriorated in the late 1960s, but they remained positive.

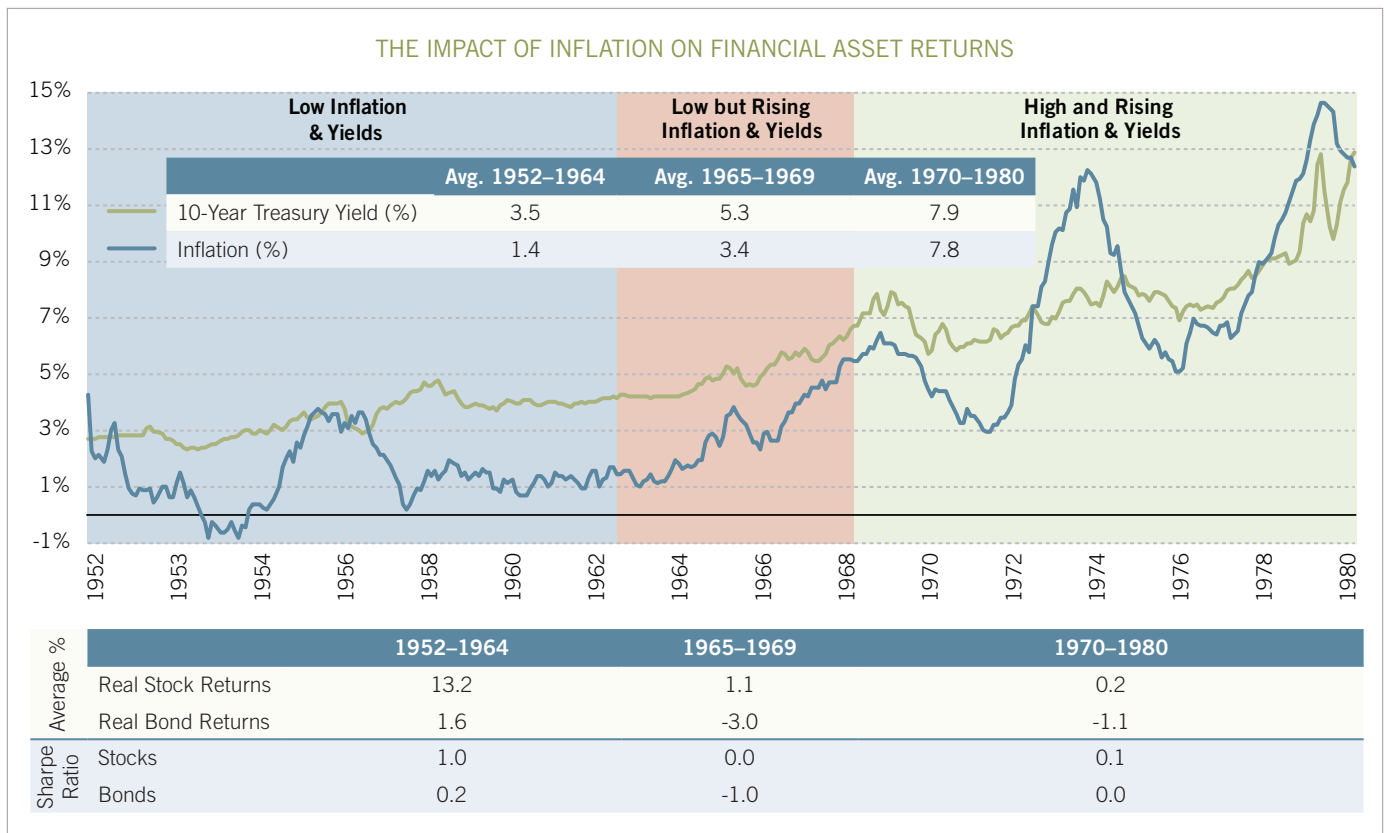
In conclusion, periods of rising and higher inflation have often resulted in lower-than-average real returns for equities. However,

because equities have characteristics that may hold up better in an inflationary environment, they provide better potential to earn positive real returns. During the past 30 years, equity investors have largely been able to ignore inflation as a source of risk due to the secular trend of disinflation and declining interest rates. From today's historically low interest-rate levels, the potential of equities to outpace inflation is an important risk-management consideration, even if inflation does not rise above historically average levels as seen during the 1970s.

### Evaluating the economic backdrop and intermediate-term outlook

Despite the relatively compelling valuation and strategic reasons to own U.S. equities, concerns about the prospects of the U.S. economy have led some investors to wonder whether this asset class will be able to achieve satisfactory long-term performance in the future. Many of these concerns are rooted in a sense that the U.S. economy may be in the early stages of a long-term decline, with supporting evidence cited that includes the sluggishness of the recovery since the 2008 financial crisis, a worsening demographic profile, and a deteriorating long-term fiscal environment.

EXHIBIT 6: Rising and higher inflation led to deteriorating real and risk-adjusted returns in both equities and bonds during the late 1960s and 1970s, but real returns to stocks remained positive.



Stocks represented by total returns of the S&P 500 Index, which includes reinvestment of dividends and interest income. Bonds represented by the Barclays Aggregate Bond Index from January 1976 through December 1980 and by a composite of the IA S&P Intermediate-Term Government Bond Index (67%) and the IA S&P Long-Term Corporate Bond Index (33%) from January 1952 through December 1975. Source: Robert Shiller, Morningstar EnCorr, Fidelity Investments (AART) through Dec. 31, 1980. Past performance is no guarantee of future results.

## Economic recovery after 2007-2008

In a recent publication (*Is the U.S. Economy Headed Down Japan's Slow-Growth Path?*<sup>21</sup>), we concluded that the U.S. was not likely to see its long-term potential rate of growth impacted by the recent financial crisis nor fall into a secular malaise. Relative to Japan, the U.S. property and stock bubbles were less extreme, its post-crisis policy response was quicker, and adjustments in key economic sectors (i.e., corporate, banking, housing, employment) have been much more rapid. Compared to Japan at a similar post-crisis stage, the U.S. has a more positive inflation environment underpinned by supportive central bank policy, a healthier non-financial corporate sector, stabilizing housing and banking systems, and a more advanced private-sector deleveraging process. Even the U.S. demographic outlook is more favorable than that of Japan and many other developed economies. Meanwhile, the U.S. economy retains many of its traditional strengths, including the protection of property and other legal rights, labor market flexibility, and a culture of innovation and entrepreneurial spirit.

## Corporate and market strengths

The U.S. corporate sector has perhaps even more compelling attributes than the U.S. economy (see “Active opportunities in the U.S. equity market,” right). The companies in the S&P 500 Index have generated earnings at a nominal compound annualized growth rate of 5% since the beginning of 2000, and they have continued to maintain high levels of profitability despite weak economic growth.<sup>12</sup> U.S. corporations have sturdy balance sheets, with roughly \$1.8 trillion in cash, and continue to generate strong free cash flows.<sup>13</sup> More of this money is being returned to shareholders, as more companies have continued increasing dividends and buybacks, giving back around \$250 billion in dividends and \$400 billion in buybacks over the past 12 months.<sup>14</sup> More than half of the S&P 500 has a dividend yield higher than the 10-year Treasury bond yield, and historically low payout ratios provide room for additional dividend increases.<sup>15</sup> Returns on equity have consistently remained among the highest in the world, even during periods when the U.S. economy has displayed slower growth than some other foreign economies.

Moreover, the U.S. equity market offers significant opportunities to balance risk through its own diverse characteristics. Seven out of the 10 industry sectors each account for at least 10% of the overall stock market capitalization (see Exhibit 7, page 7).<sup>16</sup> The market offers significant exposure to both cyclical and defensive businesses; for example, the consumer staples and consumer discretionary sectors are roughly equal in market capitalization.<sup>16</sup> Revenues generated by S&P 500 companies come from both domestic (two-thirds) and foreign (one-third) sources.<sup>16</sup>

## Demographics and long-term projections

In simple terms, our long-term real GDP growth expectations are based on projections of the rates of growth in population and productivity. Working-age population growth is the most important

## Active opportunities in the U.S. equity market

The depth, liquidity, and diversity of the U.S. stock market offer active investors a broad opportunity set, regardless of economic conditions or other macro factors. The following represents a sample of investment themes across the asset management division that portfolio managers have identified as compelling strategic opportunities:

### Dividend growth

Collapsing nominal bond yields and concerns about long-term growth rates have caused the market to treat distributed earnings (i.e., dividends) more favorably than undistributed earnings, resulting in multiple expansion among stocks with high payout ratios. Identifying companies with above-average yields and low payout ratios, and those most likely to increase their dividends may provide a source of active return going forward. Determining which companies have the potential to grow their dividends involves a nuanced combination of the science of backward-looking analysis with the art of forward-looking fundamental analysis of each company's cash flows.<sup>22</sup> Further, in our view, a focus on firms with robust balance sheets and management teams committed to returning capital to shareholders can help mitigate downside price risk and increase the probability of steady income generation and price appreciation.<sup>23</sup>

### Quality

After outperforming in the 1980s and 1990s, high-quality U.S. stocks—those with high returns on equity, low leverage, and stable business models—have lagged their low-quality counterparts for most of the past decade, leading many investors to shift their attention away from blue chips and other stocks with high-quality characteristics.<sup>24</sup> This market development has created a wealth of opportunities among stable, creditworthy multinational brand leaders, many of which appear poised to benefit from a reversion to the mean. Moreover, many high-quality companies have turned economic conditions to their advantage over the past few years. Slow growth often gives quality companies a chance to boost margins and take market share: Many high-quality companies used recent economic downturns as an opportunity to become more efficient by reducing the size of their workforce, improving the efficiency of their supply chains, and accelerating new-product innovation.<sup>25</sup>

### Small caps

Due to the fact that many smaller U.S. companies derive the bulk of their revenues domestically, these stocks tend to be less sensitive to global macro influences than those higher up the capitalization spectrum, and they therefore generally experience lower inter-stock correlations. Further driving the return dispersion of small caps is the probability that (cont. on p. 7)

demographic contributor to the growth in aggregate output. Over the next 50 years, U.S. working-age population growth should average only about 0.4%, roughly one-third the rate of the past 50 years (see Exhibit 8, page 8). With population growth rates below historical norms, we anticipate real GDP growth rates of just above 2%—lower than the roughly 3% average during the past 60 years.<sup>17</sup>

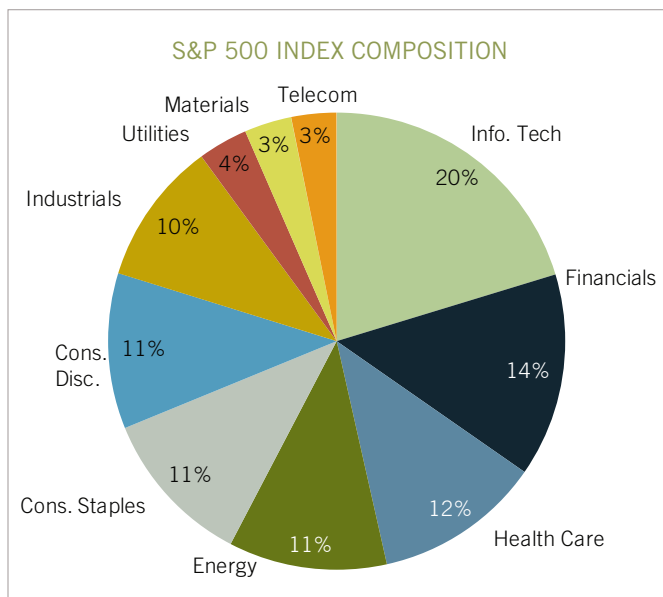
Nevertheless, this backdrop should provide a solid environment for U.S. equity returns. Equity total returns can be (and usually have been) higher than domestic GDP growth rates for a variety of reasons, including profits generated from abroad, higher productivity in the composition of the equity market than the economy as a whole, and leverage employed by the corporate sector.

### Fiscal challenges and risks

The greatest risk to this intermediate- and long-term economic and financial market outlook is if policymakers fail to take action to change the trajectory of U.S. government finances. U.S. net government debt-to-GDP levels have doubled over the past 11 years, and even that likely understates the gravity of the outlook based on the government’s massive unfunded liabilities.<sup>18</sup>

Fiscal challenges pose a number of threats. Rising debt-to-GDP levels may weigh on the confidence of businesses, investors, and consumers, and constrain the flexibility of U.S. policymakers in dealing with the slow-growth environment. Rising public debt burdens also may mitigate the productive capacity of the economy by crowding out private sector borrowing and investment, and reducing productivity-enhancing government investments such as infrastructure and basic research.

EXHIBIT 7: The U.S. equity market, as represented by the S&P 500 Index, offers a diversified exposure to multiple sectors.



Source: Standard & Poor’s, Haver Analytics, Fidelity Investments (AART) as of Aug. 31, 2012.

small firms will become acquisition targets for larger counterparts with strong cash flows. These acquirers may be attracted either by the small firms’ success, or by intellectual property such as licenses, patents, or proven research and development that the acquiring company may be able to leverage more quickly as a result of its larger scale. The depth and variety of the small-cap segment—and its inefficiency given lower analyst coverage at the individual stock level—have allowed some active investors to add value in good times and in bad. Despite the poor performance of U.S. equities overall in 2008, there were hundreds of small-cap U.S. stocks that realized positive returns during that year, which illustrates the broad range of returns and alpha-generating potential available within this category.<sup>26</sup>

### Information technology

The perception that macro forces dominate the information technology sector often obscures the positive fundamental developments taking place at an individual company level, creating inefficiency that can be exploited by experienced, well-informed active investors. The advent and adoption of new technologies and products often create opportunities that can grow irrespective of the broader economic backdrop. For example, the proliferation of smartphones over the past five years illustrates how a product can experience rapid growth even during a period of severe economic stress. Additional drivers of differentiated performance within this sector include cloud computing for server and desktop virtualization, as well as enterprise-level security, which has come to the forefront due to the rapid diversification of devices used to access company information. Strong management teams can put the right resources in place to develop best-in-class products and components to meet the needs of an increasingly demanding customer base, and by doing so they can position their firms to overcome the economic headwinds that may dampen the performance of their competition.

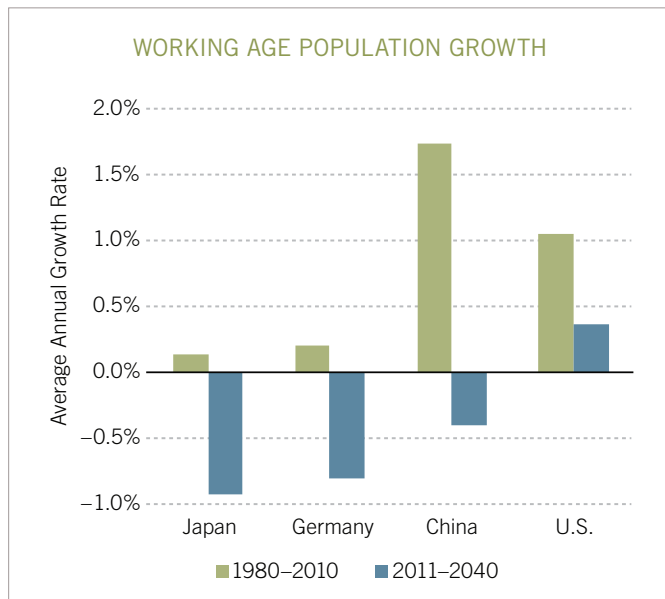
—Bruce Herring, CIO of Equities at Fidelity Investments, and Young Chin, CIO of Pyramis Global Advisors

### Outlook for the next 12 months

Our base-case scenario is that during the next 12 months, legislative progress will lead to an improvement in the medium-term sustainability of the U.S. fiscal situation. The path to achieving such progress may be bumpy. In particular, the 2013 fiscal cliff<sup>19</sup> threatens to push the economy into recession and drive down corporate profits, which would be extremely negative for the U.S. equity market.<sup>20</sup> However, the rising fiscal urgency and the prospects for a new post-election political dynamic offer a greater probability that the intermediate-term fiscal outlook will look better by the end of 2013 than it does today.

If such progress is achieved—even if it is suboptimal from an economic standpoint—it has the potential to significantly reduce

EXHIBIT 8: The reversal of demographic tailwinds will be less severe for the U.S. than for some other large economies.



Source: United Nations, Haver Analytics, Fidelity Investments (AART) as of May 31, 2011.

a key source of uncertainty that has weighed on business sentiment and equity markets during the past two-to-three years. The confidence provided by greater intermediate-term fiscal sustainability and transparency would be a key ingredient in ensuring that U.S. long-term growth prospects are not impaired. Near term, such progress would offer the potential for equity valuation expansion from today's relatively low levels by reducing the impact of policy ambiguity on investor sentiment. So although the U.S. economy still faces the potential of a slow-growth path if it fails to address fiscal problems, a long-term outlook for decent economic growth and solid U.S. equity returns may be more likely.

### Investment implications

On a more tactical basis, we continue to be cautious about the state of the global business cycle in the near term, as well as

the policy risks in Europe and the U.S. (see monthly *Business Cycle Updates* produced by Fidelity's Asset Allocation Research Team).<sup>21</sup> However, we expect the policy ambiguity that has plagued markets during the past two years will recede somewhat over the course of the next 12 months, which may provide an opportunity for stock valuations to expand as macro concerns take a back seat to more-positive corporate fundamentals.

Most critically, it may be an inopportune time for investors to consider being underexposed to U.S. equities. The primary attributes of equities—potential for capital growth, some protection from rising inflation, and diversification—are essential components to a well-conceived strategy designed to help investors meet their objectives over an extended time period. Consider:

- Starting from today's attractive valuation levels, equities have historically produced higher-than-average absolute returns over the intermediate term.
- Equities provide the potential for long-term wealth creation.
- Equities offer the potential to achieve positive real returns if inflation rises from today's low levels.
- If historical patterns are repeated, equities could experience improved risk-adjusted performance over time relative to the past decade.
- Equities continue to play a strategic role in a diversified portfolio.

Although the equity market has performed below its long-term average during the past 12 years and returns to bonds have been better, we believe that investors who are relying on the historical attributes of equities to achieve their goals may be well served going forward. Bonds should continue to play a core role in a diversified portfolio, but while many investors may have felt that owning U.S. equities over the past 12 years did not justify the risk, the greater risk during the next several years may be under-allocating to U.S. equities.



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## Endnotes

<sup>1</sup> Throughout the article, stocks are represented by the S&P 500 Index and bonds are represented by the Barclays Aggregate Bond Index from January 1976 through July 2012 and by a composite of the IA SBBI Intermediate-Term Government Bond Index (67%) and the IA SBBI Long-Term Corporate Bond Index (33%) from January 1926 through December 1975. Interest rates represented by yield on 10-year U.S. Treasury bonds. Thirty-year bond performance is from September 1981 through July 2012. Real returns of bonds and equities for 2000 to 2012 reflect performance from January 1, 2000 to July 30, 2012. Inflation represented by the Consumer Price Index. Source: Standard & Poor's, Morningstar EnCorr, Federal Reserve Board, Bureau of Labor Statistics, Haver Analytics, Fidelity Investments Asset Allocation Research Team (AART) through July 31, 2012.

<sup>2</sup> Source: FactSet, Fidelity Investments (AART) as of August 31, 2012.

<sup>3</sup> The Cyclically Adjusted Price-to-Earnings (CAPE) ratio was developed in the late 1990s by Yale professor Robert Shiller and Harvard professor John Campbell.

<sup>4</sup> Data is from January 1930 through December 1939. Source: Standard & Poor's, Morningstar EnCorr, Fidelity Investments (AART) through December 31, 1939.

<sup>5</sup> Japan's equity risk premium is the difference between the Tokyo Stock Price Index (TOPIX) earnings yield and the 10-year Japan Government bond yield. Source: Ministry of Finance, Nihon Keizai Shinbun (Nikkei), Fidelity Investments (AART) through July 31, 2012.

<sup>6</sup> Equity prices represented by the S&P 500 Index. Source: U.S. Bureau of Labor Statistics (Consumer Price Index, average rate of inflation since 1926=3.0%), Standard & Poor's, Morningstar EnCorr, Fidelity Investments (AART) through July 31, 2012.

<sup>7</sup> Source: Morningstar EnCorr, Fidelity Investments (AART) through July 31, 2012.

<sup>8</sup> Source: Standard & Poor's, Morningstar EnCorr, Fidelity Investments (AART) through December 31, 1980.

<sup>9</sup> Source: Standard & Poor's, Morningstar EnCorr, Fidelity Investments (AART) through December 31, 1980.

<sup>10</sup> Source: Haver Analytics, Fidelity Investments as of September 13, 2012.

<sup>11</sup> "Is the U.S. Economy Headed Down Japan's Slow-Growth Path?," Published February 2012 by Fidelity's Asset Allocation Research Team.

<sup>12</sup> Source: Standard & Poor's, Morningstar EnCorr, Fidelity Investments (AART) through July 31, 2012.

<sup>13</sup> Source: Federal Reserve Board, Haver Analytics, Fidelity Investments (AART) through March 31, 2012.

<sup>14</sup> Source: Standard & Poor's, Fidelity Investments (AART) through June 30, 2012.

<sup>15</sup> Source: Standard & Poor's, Fidelity Investments (AART) through August 31, 2012.

<sup>16</sup> Source: FactSet, Fidelity Investments (AART) through August 31, 2012.

<sup>17</sup> Source: Fidelity Investments (AART) through August 31, 2012.

<sup>18</sup> Source: Federal Reserve Board, Haver Analytics, Fidelity Investments (AART) as of August 31, 2012.

<sup>19</sup> Fiscal cliff: The term Federal Reserve Chairman Ben Bernanke has used to describe significant fiscal decisions coming up in Washington at the end of 2012 and the beginning of 2013. It includes the expiration of the Bush-era tax cuts, expiring fiscal stimulus, and a number of other provisions on the tax side. On the spending side, there are cuts that go into implementation in January 2013, and then over the next decade, stemming from the failure of the deficit reduction super committee and the debt ceiling debate in 2011.

<sup>20</sup> Source: Office of Management and Budget, Fidelity Investments (AART) through December 31, 2011.

<sup>21</sup> Business Cycle Update: a monthly analysis of influential economic and other factors tied to the U.S. business cycle published in the third or fourth week of each month by Fidelity's Asset Allocation Research Team.

<sup>22</sup> For more information, see "Looking Backward and Forward at Dividend Growth," a September 2012 *Fidelity Leadership Series* paper authored by Portfolio Manager Scott Offen, Institutional Portfolio Manager Naveed Rahman, and Mega Cap Research Analyst Emma Baumgartner. Past performance and dividend rates are historical and do not guarantee future results. It is inherently difficult to make accurate dividend growth forecasts and the outcomes from those forecasts are not guaranteed.

<sup>23</sup> For more information, see "What if the Market is Revaluing Dividends?," a March 2012 *Fidelity Leadership Series* paper authored by Portfolio Manager James Morrow and Quantitative Analyst Neil Nabar.

<sup>24</sup> Source: Haver Analytics, FactSet, Fidelity Investments (AART) as of September 15, 2012.

<sup>25</sup> For more information, see "Capitalizing on Inefficiencies in Mega Cap Equities," a June 2012 *Fidelity Leadership Series* paper authored by Portfolio Manager Matthew Fruhan, Institutional Portfolio Manager Naveed Rahman, and Quantitative Analyst Alex Devereaux.

<sup>26</sup> During 2008, 477 companies in the small-cap-oriented Russell 2000 Index generated a positive return. Source: FactSet, as of September 15, 2012. For more information, see "U.S. Small Caps: Outperformers During Rising Rate Environments," an August 2012 *Fidelity Leadership Series* paper authored by Portfolio Manager Ethan Hugo and Investment Director Benjamin Treacy.

## Other important information

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop dynamic asset allocation recommendations for the Global Asset Allocation Division of Fidelity Investments.

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References to specific investment themes are for illustrative purposes only and should not be construed as recommendations or investment advice. Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

## Past performance is no guarantee of future results.

Keep in mind that investing involves risk. The value of your investment will fluctuate over time and you may gain or lose money.

## Diversification does not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

Correlation coefficient measures the interdependencies of two random variables that range in value from -1 to +1, indicating perfect negative correlation at -1, absence of correlation at 0, and perfect positive correlation at +1.

Standard deviation (square root of the variance): Shows how much variation there is from the "average" (mean or expected value). A low standard

deviation indicates that the data points tend to be very close to the mean, whereas a high standard deviation indicates that the data points are spread out over a large range of values.

The Sharpe Ratio compares portfolio returns above the risk-free rate relative to overall portfolio volatility (a higher Sharpe Ratio implies better risk-adjusted returns).

Active return: The return of a portfolio minus the return of the portfolio's benchmark.

Payout ratio: The payout ratio is the dividend paid out over the year divided by the earnings over the year. A low payout ratio indicates dividend growth potential, while a high payout ratio indicates less cash to increase dividends.

Alpha: The return on an asset in excess of the asset's required rate of return; the risk-adjusted return.

The IA SBBI U.S. Intermediate-Term Government Bond Index is a custom index designed to measure the performance of intermediate-term U.S. government bonds. The IA SBBI U.S. Long-Term Corporate Bond Index is a custom index designed to measure the performance of U.S. corporate bonds.

CPI: Consumer Price Index. An inflationary indicator that measures the change in the cost of a fixed basket of products and services, includ-

ing housing, electricity, food, and transportation. The CPI is published monthly.

The Barclays U.S. Treasury Index is designed to cover public obligations of the U.S. Treasury with a remaining maturity of one year or more. The Barclays U.S. Aggregate Bond Index is an unmanaged, market value-weighted performance benchmark for investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year.

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