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STOCKS WILL GO WHERE PROFITS GO - THAT'S ALL THERE IS TO IT

By Arin Ruttenberg, Financial Advisor at Brenthurst Wealth at Sandton

Market turmoil over the past two years caused various shocks to investors. Some are uncertain on the way forward. Understanding a few fundamentals can calm the nerves and assist with a successful future investment strategy.

One of my top three legendary investors, **Peter Lynch**, who ran the Fidelity market-beating Magellan Fund for 13 years and whose books, *One up on Wall Street* and *Beating the Streets* (both of which I have read), made an important observation in a [speech he gave to the National Press Club](#) of the US in October 1994.

THE MOST IMPORTANT PART OF THE SPEECH READ AS FOLLOWS:

"Some event will come out of left field, and the market will go down, or the market will go up. Volatility will occur. Markets will continue to have these ups and downs. ... Basic corporate profits have grown about 8% a year, historically. So, corporate profits double about every nine years. The stock market ought to double about every nine years. So, I think - the market is about 3 800 today, or 3 700 - I'm pretty convinced the next 3 800 points will be up; it won't be down. The next 500 points, the next 600 points - I don't know which way they'll go. So, the market ought to double in the next eight or nine years. They'll double again in eight or nine years after that. Because profits go up 8% a year, and stocks will follow. That's all there is to it."



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When he says “the market,” he is referring to the Dow Jones Industrial Average, which closed at 3 797 on the day he gave the speech. If you compound that by an 8% growth rate to the present day, then you get 31 520. The Dow closed at 34 583 during the time of writing – pretty close to the upside.

If you did this exercise with the S&P 500, which closed at 455 on the day of Lynch’s speech, then you’d get 3 778, assuming an 8% compound annual growth rate. At the time of writing, the S&P 500 closed significantly higher at 4 500.

According to [S&P Dow Jones Indices](#), S&P 500 earnings per share (EPS) were \$30.11 for the 12 months ending Q3 1994, around the time Lynch gave that speech. If you compounded that by 8% to the present year, you’d get \$250. S&P Dow Jones Indices estimates EPS for the 12 months ending March 2022 was actually \$211, which is fairly close. (They estimate S&P EPS will be \$246 in 2023.)

His point was that markets trend over long-term periods, whilst acknowledging short-term volatility. If you allow him some margin of error, to account for unpredictable short-term swings, then you may be able to better appreciate how his thoughts speak to some fundamental market truths we often find ourselves repeating.

I have picked out three important elements from Lynch’s speech, which are critical for investors to understand:

1. “Some event will come out of left field, and the market will go down, or the market will go up. Volatility will occur.”

There are risks that some people will talk about, while others will not discuss those risks at all.

[Russia’s invasion of Ukraine](#) is a good example. For investors, a conflict between Russia and Ukraine had not been a concern, although there had been tensions between these countries for years, so markets weren’t prepared for the eventual invasion. This would explain why stocks went into a deep correction amid the initial news and build up.

With these types of events, [volatility will remain high as markets digest every positive and negative development](#) as the situation unfolds.

This stands in contrast to the risks everyone has been talking about, such as inflation and tighter monetary policy. These risks had investors concerned for months before those fears were confirmed, and the actual news eventually had a limited effect on market volatility as it was priced in.

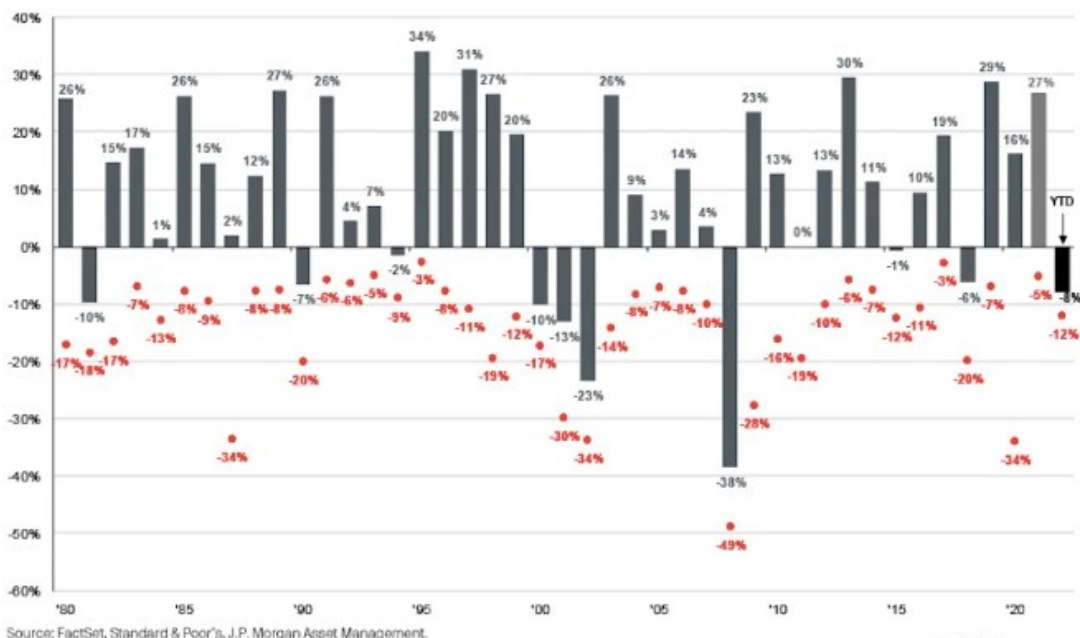
2. “I’m pretty convinced the next 3 800 points will be up; it won’t be down. The next 500 points, the next 600 points – I don’t know which way they’ll go.”

Over time, the stock market’s biggest moves have been to the upside and the long-term approach is undefeated. But you can certainly get hurt in the short term, which is what Lynch was referring to with the “500 to 600 points” comment.

[Big selloffs are normal](#) and corrections are healthy, whilst it may not seem so at the time. The S&P 500 experiences an average maximum drawdown of 14% a year.

S&P INTRA-YEAR DECLINES VS CALENDAR YEAR RETURNS

Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years



According to the graph, the latest market correction has seen the S&P 500 fall 12% from its high of 2022, which is less serious than average.

3. “Profits go up 8% a year, and stocks will follow. That’s all there is to it.”

Historically, the stock market has usually gone up because earnings have usually gone up. That is because earnings is the most important driver of stock prices.

The below graph from Fidelity investments, with data dating all the way back to 1871, shows the tight relationship between earnings and stock prices.



Stock prices are on the vertical axis, with earnings on the horizontal axis. The R-squared (a statistical measure of how close the data is to the fitted regression line) of 0.9686 in this linear regression is very close to 1, showing a high correlation, which means earnings do a great job of driving stock prices. An investor's only true defence in growing their investments is decades, not five or seven years, and over this time stocks will go where profits go. And as Lynch said, "that's all there is to it." ***Speak to an experienced, qualified financial advisor to navigate market movements to suit your financial goal and strategy.***

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BUILDING GLOBAL WEALTH
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WEBINAR
18 MAY 2022 14:00 - 15:30

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GLYN OWEN | INVESTMENT DIRECTOR, MOMENTUM, **TONY BELL** | CHIEF INVESTMENT OFFICER, THINKCELL

WEBINAR INVITATION | 18 MAY 2022 AT 14:00

Join our webinar "Building Global Wealth: Fund managers' perspectives" to listen to the views of three leading fund managers on what lies ahead. **Magnus Heystek**, Director and Investment Strategist of Brenthurst Wealth, will introduce **Glyn Owen**, Investment Director at Momentum Wealth International, **Tony Bell**, Chief Investment Officer at ThinkCell and winner of several Raging Bull Awards, and **Tavonga Chivizhe**, Chief Investment Officer at Boutique Investment Partners.

CLICK HERE TO REGISTER FOR THE WEBINAR | WED 18 MAY 14:00 <https://www.bwm.co.za/seminars/>

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