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Equities vs. Fixed Income

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When we analyze the current environment, the greatest investment opportunity we see is in large, dividend paying, domestic companies. Corporate Balance Sheets may be in their best shape in decades. Valuations based on earnings are not only inexpensive on a historical basis but also relative to the fixed income markets. Dividends remain an important part of this thesis and look particularly attractive in light of historically low bond yields. Our optimism for the future remains bright and though the positive ramifications of massive stimulus are declining, we believe the economy will continue to expand at a reasonable rate.

How do we compare the attractiveness of equities with fixed income? Comparing the earnings yield of a stock with the yield to maturity of a bond creates an excellent benchmark. The earnings yield is simply the inverse of the often discussed Price to Earnings (P/E) metric. In other words, if a stock trading at \$50 earns \$4 it trades at a P/E of 12.5 times (\$50 share price / by \$4 in earnings) and also trades at an earnings yield of 8% (\$4 in earnings / \$50 stock price). As a whole, the Standard & Poor's 500 Index trades with an earnings yield of 8% in comparison to 10 Year Treasury bonds with a yield to maturity below 3%. According to Oppenheimer strategist Brian Belski, the difference between these metrics has not been this wide since the late 1970's and the average one-year return for the S&P has been 26.7%.

Given that dividends are an actual payment of cash to shareholders while earnings are retained, examining dividend yields in comparison to interest yields is perhaps a more conservative approach. Equities score quite well in this exam as well. The current dividend yield on the S&P 500 is 2.1% and increases to 2.3% when focusing on the S&P 100 Index, the 100 largest companies within the S&P 500. 38 companies in the S&P 100 have increased their dividend over the past 12 months and 22 of these stocks now yield more than 10 year Treasuries. We expect this number to continue higher once the strongest banks are allowed by regulators to return to paying dividends. Though we find ourselves in an environment with little current inflation, when it rears its ugly head in the future fixed income investors will be at a substantial disadvantage to equity investors that have the opportunity for capital gains in addition to their dividend payments.

In a recent interview, Leon Cooperman, founder of investment firm Omega Advisors and former Chief Investment Officer at Goldman Sachs Asset Management discussed the current environment and why one should seriously consider investing in equities: "In financial assets, what are my choices? I can keep my money in a bank earning 0%. I can go out and buy a 10 year government bond yielding 2.9% when I know in my heart of hearts that all this stimulus is going to be inflationary and adversely affect interest rates. Or I can go out and buy some good company trading at 12 to 13 times earnings, yielding 2, 3, or 4%, and is growing. The choice to me is an easy one." We couldn't agree more.

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