HILLIARD LYONS TRUST COMPANY LLC

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Lower Returns Likely in the Years Ahead

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Regular readers of this commentary know that we're not in the habit of making bold predictions. We simply don't think that most investment variables can be predicted with an acceptable degree of certainty. We prefer to focus on the strength of individual investments that we consider for our clients' portfolios under a variety of circumstances. We then invest in securities that we think will produce the most attractive risk-adjusted rates of return over several years.

Given our normal reticence in predicting the future, the following statement may seem peculiar:

We expect investment returns over the next five years will be significantly lower than those of the last five years.

While we don't make bold predictions, we do try to manage investor expectations. When we have a strong opinion about the potential returns available in the markets, we tell you. For instance, at the time of the stock market lows in early 2009, we stated in our commentary that, "We believe there are more attractive investment opportunities in the stock market today than at any time in recent history …. It is at times like these that the most attractive business franchises in the world are on sale." Six years later, we think circumstances are much different. In fact, we expect returns from both bond and stock portfolios will likely be much more modest in the years just ahead.

The outlook for bonds: It is easy to see why we expect modest returns from bonds over the next several years. With a 10-year Treasury bond currently yielding 2.3%, a high-quality 10-year corporate bond yielding slightly more than the Treasury but less than 3%, and many shorter-term bonds yielding 1% or less, investors are likely to earn the coupon rate on most bonds under the best of circumstances. If rates rise, as many pundits expect, bond returns are likely to be less than the coupon rate, because prices of longer-term bonds decline in a rising interest rate environment.

The outlook for stocks: It is also easy to understand why we expect lower returns from stocks in the years ahead compared to the experience of recent years. The returns from stocks over the past five years have been outstanding, with the total return of the S&P 500 compounding at 17.3% annually. Mid- and small-cap stock returns have been equally impressive, with the S&P MidCap 400 index compounding at 17.8% and the S&P SmallCap 600 returning 18.4% annually. Stock returns have been driven by increasing corporate earnings per share and an increasing valuation that investors have been willing to pay for those earnings. It is this second element – investors' increasing valuation of earnings – that is unlikely to recur in the years ahead.

How We Got Here

Let's look back at how we arrived at today's valuations.

Five years ago, the economy was working its way out of the severe recession of 2008-2009. Investors were understandably despondent after a gut-wrenching stock market decline, and stock valuations were quite low. The price/earnings ratio of the S&P 500 was about 12 times earnings. Over time, the economy recovered in fits and starts, and corporate earnings increased. With the Federal Reserve most worried about deflation in a debt-heavy world, interest rates were driven to artificially low levels by very accommodative Fed policies.

As inflation and interest rates persisted at very low levels, stock market valuations rose steadily. It makes perfect sense that corporate earnings should be capitalized at a higher rate in a sustained low-inflation and low-interest-rate environment. Corporate earnings are simply worth more to an investor in a low-interest rate world. Consequently, the price/earnings ratio of the S&P 500 has risen to 18 times earnings today – a 50% valuation increase. This increased valuation priced into stocks is unlikely to move higher in the years ahead.

Possible Scenarios

While no one can consistently predict short-term stock market movements, we do believe that stock valuations make sense over longer periods. Over the next five years, we see three possible return scenarios for the stock market:

(1) First, *if inflation and interest rates remain low for the next several years*, the current market valuation is likely to persist. In this case, investors will earn returns equal to the growth rate in corporate earnings per share.

(2) Second, *if inflation and interest rates move consistently higher*, valuations are likely to soften. If this scenario plays out, investors will earn the corporate earnings growth rate less the valuation decline.

(3) Third, *if valuations continue to consistently rise over the coming years*, stocks would likely enter a period of increased optimism and elevated risk due to overly aggressive valuation. While we consider this last scenario to be the least likely of the three, we will be careful if it occurs.

The Stock Market Paradox

The stock market presents a difficult paradox: When the news of the day is depressing, investors are in a state of heightened fear, and stock prices are very low. We were there five or six years ago. Conversely, when exciting growth is occurring in the economy, investor optimism runs high, and stock prices soar to ever-higher valuations. This set of circumstances was best exemplified in the late 1990s, with the internet bubble leading the way.

The conundrum of the market, simply stated, is that *the least risky time to invest in stocks is when investors are generally fearful and valuations are low, while the most risky time is when investors are full of optimism and valuations are unsustainably high.* We don't believe that we are near either of these extremes today, but we will be wary if stock market optimism grows excessive and valuations continue to increase.

Our primary message is that you should expect lower returns over the next five years compared to those experienced over the past five years. This statement speaks more to the strong returns of recent years than to dire future expectations. Mathematically, it is hard to see how returns from high-quality bonds could be any higher than the current, historically low, coupon rates. In the stock market, returns are unlikely to exceed the rate of per-share corporate earnings growth. Valuations should not continually increase, especially if interest rates have already bottomed out. None of these expectations are a warning that we are entering a particularly difficult period. Rather, we think you should set your expectations to realistically achievable levels. Successful investing generally requires that investors always try to think rationally and adjust expectations to reasonable levels.

How We Will Proceed

While we think investment returns are likely to be more modest in the coming years, we will continue to work diligently to provide you with attractive investment performance. In the current investment environment, we plan to maintain our strategy of filling our clients' portfolios with high-quality securities that are vigorously analyzed as to potential returns and possible risks. And we always take a long-term perspective in everything we do. That includes the many lengthy relationships we have with clients like you. We are grateful that you continue to choose Hilliard Lyons Trust Company as your investment manager.

Past performance does not necessarily predict future results, and historical prices and returns may not be achieved in the future.

Hilliard Lyons Trust Company, LLC does not provide tax or legal advice. Clients should consult with their own attorneys and accountants regarding their own individual situation.

Should you have questions about the information contained in this Investment Update or regarding your investments, please contact your Hilliard Lyons Trust Company Portfolio Manager.

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