



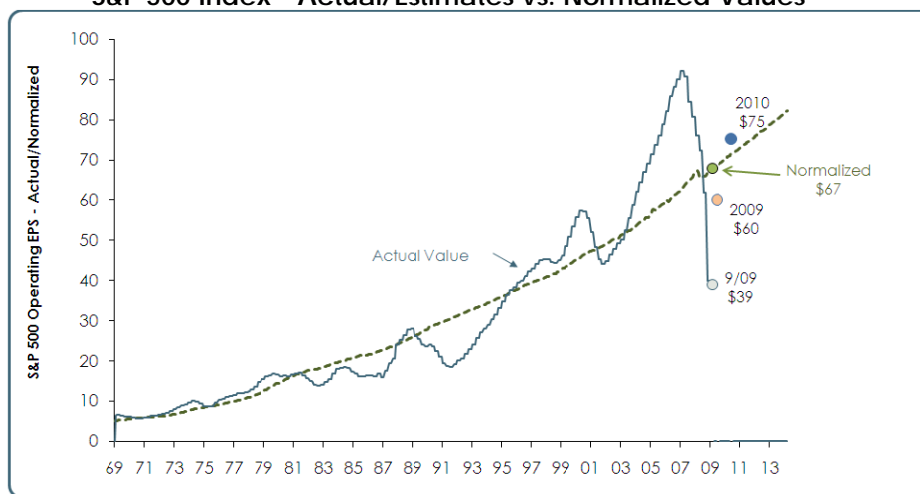
How High is Up?

In our last report, we discussed how markets tend to ignore long-term secular issues until faced with crisis and how equity markets typically follow earnings expectations for twelve to twenty-four months. I find this short-term outlook to be one of the most frustrating aspects of human behavior. It is, however, a reality. At present the market has the potential to rise significantly. Yet at the same time, it is becoming more expensive relative to mid-cycle normal levels of earnings. Given these mixed circumstances, we would overweight 'risk assets' in a diversified manner and make use of equities, higher risk fixed income and special strategies that are not highly correlated to the equity market.

Following Earnings Up and Down the Roller Coaster

The chart below illustrates operating earnings over time. I look at this at least once a week to remind myself that earnings expectations are what really matters to a large percentage of investors. When earnings rise faster than trend rates, stocks perform well. This was evidenced in the late 90's and again from 2003 to 2007 during the housing recovery/bubble. When earnings peak, as in 2000 and 2007, the market peaks. When earnings collapse, the market collapses. We are now in such an upswing and stocks are rising.

Historically, Earnings Have Been Cyclical
S&P 500 Index - Actual/Estimates vs. Normalized Values



Sources: Glenmede Investment Research, Haver Analytics and FactSet (First Call projected bottom-up EPS estimates)

10/1/09

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(continued)
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	Estimated EPS	X	P/E	=	Estimated Value	Premium (Discount)
Estimated 2010 EPS	75		15		1125	6%
Estimated 2009 EPS	60		15		900	-15%
"Trendline/Normalized" EPS	67		15		1005	-5%
Estimated Cyclical High EPS	100		17		1700	61%
Estimated Cyclical Low EPS	39		12		468	-56%
Current S&P 500 Index					1057	

So what is the near term outlook for earnings? According to consensus estimates, earnings will go to \$75 by the end of 2010. If we assume a market P/E of 15, this implies an S&P 500 index value of 1125, or about a 6% appreciation over the next year (or 8% in total return if you add a 2% dividend yield). I would certainly be happy with this number, and in the absence of other information, this is not a bad one-year estimate for stock market returns. As with all one-year forecasts, this projection should be taken with a grain of salt. Behavioral finance experts explain that investors underestimate the range of possible results. Given the uncertainties in the economy, this seems a reasonable assertion.

Let's put this rough and dirty forecast to some questions from the skeptics, pessimists and optimists.

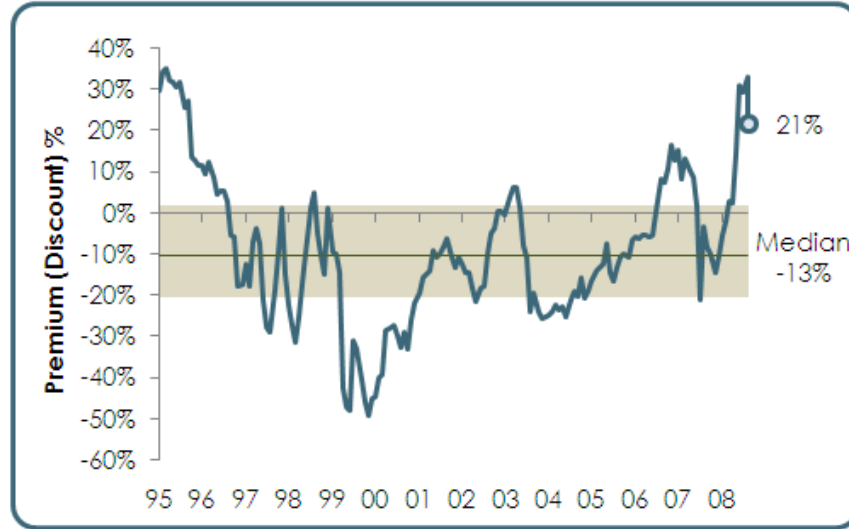
Let's start with questions from the optimists (this will be brief):

- Q. Why is the estimate for earnings so modest? Surely with a recovery we could go higher?
- A. Yes, earnings can go much higher. If we were to approximate an earning's peak for this cycle, it could be \$100 per share. If investors put an above-average-multiple on earnings of 17 when they get complacent, as is the tendency, then the S&P 500 could go to 1700 or rise about 60%.
- Q. Doesn't Asia present a huge growth opportunity?
- A. It does but those markets look pricey right now and you don't need to be directly invested to profit.

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MSCI ASIA exc. Japan versus MSCI WORLD

Relative Price/Cash Earnings



Sources: Glenmede Investment Research and FactSet

Some U.S. and European companies do a fairly good job of exporting to Asia and the Middle East. In addition, investments in hard assets (*i.e.* metals), or stocks that mine hard assets, are in essence a play on growth in Emerging Asia.

Unfortunately, optimists generally don't ask too many questions. They just go ahead and buy. Not surprisingly, we have a lot more questions from the skeptics and pessimists.

Questions from the skeptics and pessimists – but what about...:

- Q. You base your one-year-forecast on analyst estimates, but don't Wall Street analysts tend to be too optimistic?
- A. Wall Street analysts are usually too pessimistic on the way out of a recession and too optimistic on the way in. If anything, we guess they are too pessimistic at this point in the cycle.
- Q. Isn't it true earnings estimates are positive because companies have been cutting costs? However, they can't cut costs forever. Eventually there has to be revenue growth. People and businesses need to buy more but given current economic conditions, how likely is this to occur?
- A. It is true that eventually revenues need to grow. At this stage of the recovery, however, most of the gains will come from cost controls and this trend may continue. American businesses have become quite good at becoming productive by eliminating less profitable lines of business and through more efficient use of technology. In addition, as discussed in

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our last review, revenues have been coming in at surprisingly positive levels for half of the companies in the S&P 500. This may indicate that revenues will contribute to the bottom line sooner rather than later.

- Q. But is it really correct to value companies based on what they will earn over the next twelve months? The true value of a company should reflect what it earns normally – not at a cyclical high or low!
- A. We agree with you on this point. Companies should be valued based upon their earnings on a normal mid-cycle basis. But what is normal?
- Q. Didn't your parents teach you not to answer a question with a question? You're the answer person. How do you arrive at a normal level of earnings?
- A. For the market as a whole, we make a rough estimate for normal earnings by drawing a trend line through historical earnings growth just as we did in the chart that follows. A trend line is a nice mathematical way of demonstrating that good times tend to be followed by bad times, and visa versa.

You may notice the trend line in the graph doesn't look smooth. This is because we actually calculated the trend line for growth in real (or inflation-adjusted) earnings. In the first chart, we add inflation back in.

Since inflation varies over time, the line isn't smooth. The reason we calculate the trend for real earnings growth is that real earnings should be related to real GDP growth. Real GDP growth is relatively constant over long periods and correlates to fairly stable factors such as workforce and productivity growth rates. Inflation on the other hand is a matter of public policy. We have experienced long periods when central bankers have tolerated either very high or low inflation. Calculating a trend line based on earnings unadjusted for inflation may draw a distorted picture of normal earnings power.

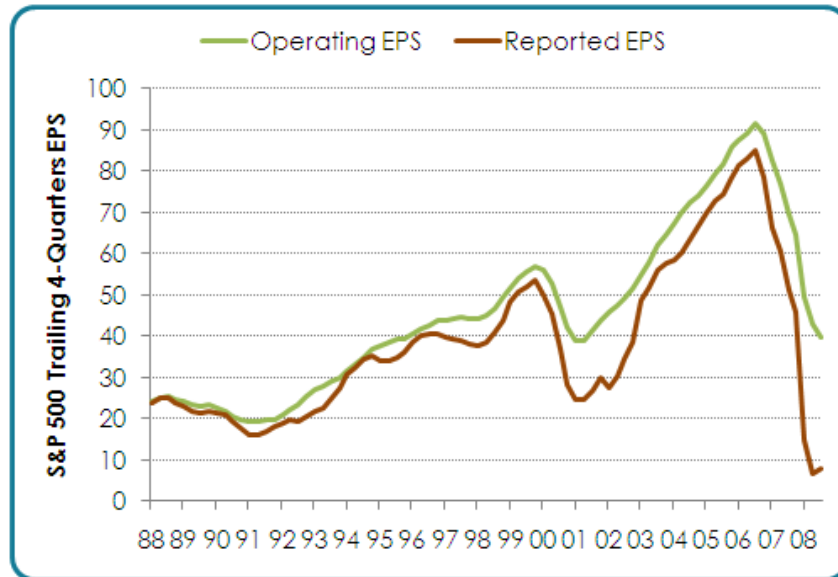
Finally, we have adjusted for the fact companies have been taking more write-offs. Analysts generally estimate operating earnings, which exclude write-offs, based on the rationale that operating earnings do a better job of projecting future earnings growth based on ongoing operations.

Unfortunately, write-offs are a real part of investing in stocks and they have become significantly larger if you look at the gap between reported and operating earnings. If you invest in an index of stocks, there will be earnings write-offs in the future. A portion of those write-offs should be considered a normal part of operating earnings. Hence, the trend line we drew does not actually go through the center but a little lower.

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S&P 500 Operating and After-Tax Earnings Per Share

December 31, 1988 Through June 30, 2009



Sources: Glenmede Investment Research and Haver Analytics

- Q. So after all of those adjustments and qualifications, what is the normal mid-cycle level of earnings for the S&P 500?
- A. Currently it is about \$67 growing at a real rate of about 2% per year.
- Q. And what does that mean for the fair price of stocks?
- A. If we apply a P/E of 15, it would mean a fair value of 1005 on the S&P 500. The gap between actual index values and the theoretical normal value is not at an extreme. And since there is a lot of room for argument as to how to calculate normalized earnings, it would be a mistake to draw too precise a conclusion. However, based on our measures, we are clearly at a premium value for the S&P 500 at this point.
- Q. If we combine this information with the fact that government bond yields are at extremely low levels, does this mean the world's central banks are engineering another asset bubble using government debt rather than consumer and financial company debt?
- A. You would have thought they would have learned their lesson.
- Q. You didn't answer the question.
- A. Didn't I?

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