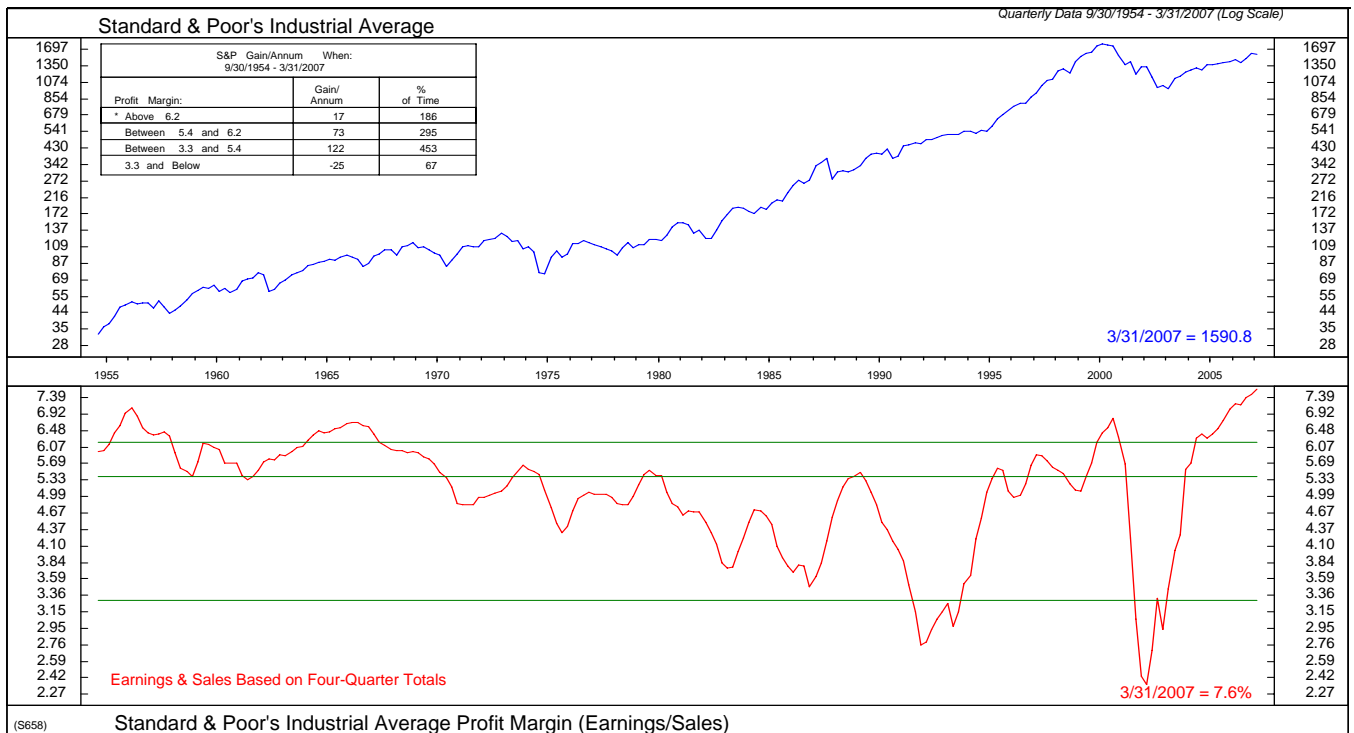
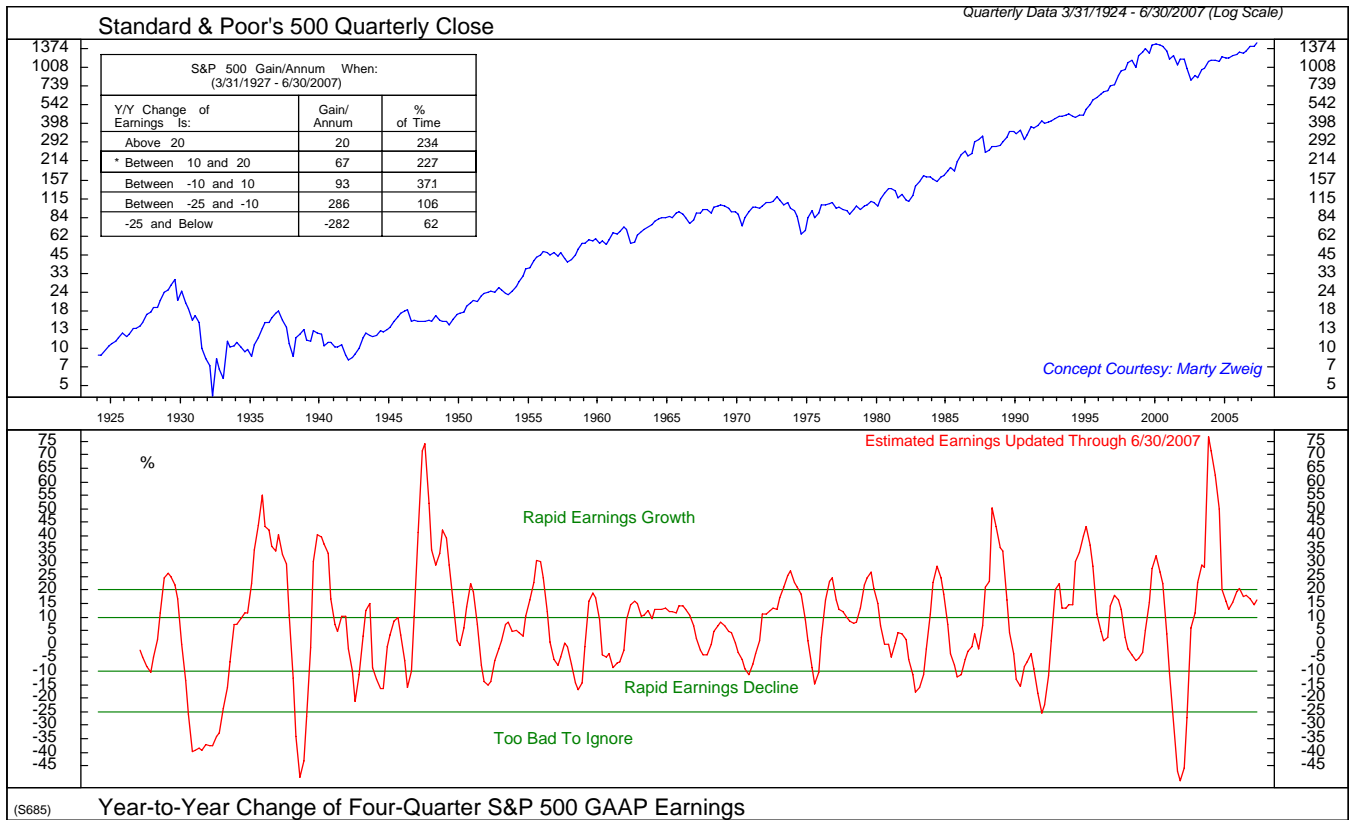


Earnings Growth Does Not Matter. Really.

After sudden market declines, industry and government officials seek to reassure us that all is well because of current earnings growth and high profit margins in corporate America. The officials certainly *sound* reassuring, and many investors *do* need occasional reminders that the financial market movements ultimately rely on underlying business fundamentals. It sounds logical that earnings growth and high profit margins lead to rising stock prices and good investor returns, and this is what most investors believe. Unfortunately, the empirical evidence does not support it.

We are not claiming that disaster is around the corner, just that the logic most commonly cited for the belief that all is well is invalid for two reasons. First, as the charts on the next page (courtesy of Ned Davis Research, Inc.) show, earnings growth and profit margins are highly cyclical. You cannot just extrapolate the recent past. Second, these numbers reflect the past, while the stock market discounts the future. When earnings growth is rapid, the S&P 500 index has returned only 2 percent per year. When profit margins are high, the return on the Standard & Poor's Industrial Average has been even less, only 1.7 percent per year. Recent readings for both have been high, but both were at record lows just a few years ago. We find no indication in these charts of a burgeoning "new era" banishing the cyclicity of the past.

Profit margins and earnings growth are important for the economy over the long run, but not for predicting the stock market in the short run. Citing the current numbers is looking through the rearview mirror while the financial markets are looking through the windshield. The talking heads are trying to comfort investors, an admirable endeavor, but their logic relies on an assumed relationship between the past and the future that simply does not exist in the real world.



If you would like investment advice based on evidence, not comforting fiction, call us at (503) 419-3938 or check www.sigmainvestment.com. True comfort lies in correctly perceiving reality.