A Shift To Stocks Can Help Investment Returns Keep Pace In Changing Markets

(NAPSA)—Investors looking for growth of capital and income may want to consider increasing their allocation to stocks, advises the team of investment professionals from Eaton Vance Corp. Seventeen rate hikes over nearly three years have led to a situation where bond investors are paid more for owning short-term bonds than longer-term ones. This somewhat unusual situation creates a dilemma, and investors may want to add to stock holdings to help the return prospects of their investment portfolios, explained Duncan W. Richardson, chief equity investment officer at Eaton Vance.

Over the past two and a half decades, interest rates have decreased steadily as globalization and technology have combined to keep secular inflation in check. Richardson expects interest rates to stay in their current 4 to 5 percent range for an extended period. Bonds may return only half of their relatively healthy historical returns over the past several decades. He also anticipates that yields on cash (such as bank certificates of deposit), which are currently around 5 percent, may also not be so attractive in a year or two.

"Although the direction of the economy is uncertain, increasing stock and bond market volatility, the delayed effects of rate hikes and higher commodity costs could cause an economic slowdown along with a deceleration of corporate earnings," Richardson said. "We believe this environment may result in potential changes in market leadership, making it ideal for investors who have an ability to sort out industry and company fundamentals on a stock-by-stock basis."

The good news is some stocks are relatively inexpensive and may even provide a competitive source of income compared to bonds. The average price/earnings (P/E) ratio, a common measure of the relative value of stocks, has compressed from about 25 to 15. Richardson feels the uncertainty has depressed multiples and predicts that the P/E ratio of the S&P 500 will remain steady and may even expand once it is clear the economy is slowing. Stocks can provide significant capital appreciation to longer-term investors that bonds may no longer be able to offer. Additionally, with some corporations returning more cash to shareholders, equity investors might potentially receive a rising source of dividend income that is tax-advantaged through 2010.

Corporate earnings of S&P 500 companies are currently at record levels—double what they were in 2002—providing good fundamental support to the stock market. The stocks listed on the Standard & Poor's 500 Index generate nearly $90 of high-quality earnings per share. Mr. Richardson believes that higher-quality is largely a result of Sarbanes-Oxley (SARBOX) legislation that was passed in 2002 with provisions for improved corporate governance. Richardson also believes that improved SARBOX controls may permit S&P earnings to continue to increase over the next several years.

"Growth and value investors should find the valuation and volatility of the equity market, especially the larger stocks, to be tolerable over the next three to five years," Richardson believes. "The stock market should return to its historic performance range of 7 to 8 percent, so we believe every investor—whether conservative, moderate or aggressive—may benefit by significantly increasing their exposure to stocks."

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