

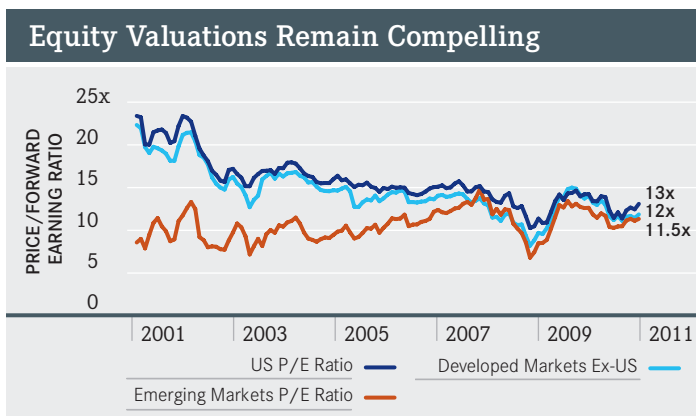
After the Lost Decade: Strategies for Re-Entering Equity Markets

Point of View with Chris Leavy

- ▶ The past decade has been rough on investors, with equity valuations declining to historically low levels.
- ▶ Today, equities as an asset class are supported by strong corporate balance sheets and earnings growth and are well positioned to return significant value to investors over the coming years.
- ▶ Investors should consider global multinational stocks with dividends for income and exposure to emerging markets growth.

As investors look back over the decade that recently ended (2000–2010), they see that their equity investments essentially produced a zero percent return. What happened during that time to produce this “lost decade”?

It has been a rough ride for investors. Over that period,* the US economy experienced the bursting of two major asset bubbles (tech and housing), two momentous recessions and two bear markets for equities. At the same time, the economy lost some significant companies like Enron, Arthur Andersen and WorldCom, not to mention the gigantic financial firms that failed during the credit crisis.



Sources: Bloomberg, Factset.

* Time period referred to in this piece runs from December 31, 1999, through December 31, 2010.

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Chris Leavy, Managing Director, is BlackRock’s Chief Investment Officer of US Fundamental Equity. Prior to joining the firm, Mr. Leavy spent 10 years at OppenheimerFunds, where his most recent role was Chief Investment Officer for the firm’s \$80 billion equity group. He also ran and built out the firm’s Value Equity Team, where he was recognized by Barron’s as a top 100 manager.

What those calamitous events caused over the course of the decade was a compression, or decrease, in the price-to-earnings (P/E) multiple (obtained by dividing the stock price by the projected earnings) investors were paying for US stocks.

Over the decade, the forward P/E multiple that investors paid for US equities declined from a high of 24x in 2001 to where it is now, at about 13.3x 2011 earnings (see chart called “Equity Valuations Remain Compelling”). As you can see, multiples for non-US companies in other developed markets also declined significantly over the decade. Emerging markets, on the other hand, did not see similar P/E compression, and actually saw their multiples rise slightly from 9x to 11.5x.

Should investors be concerned about the potential for another lost decade?

Just the opposite. For investors to experience another lost decade, P/E ratios would have to decline another 40%, to an unprecedented level. This is something we just don’t think could happen. We fully believe there are multiple reasons equities are a strong long-term wealth-generating investment.

First, companies generate cash, which is the fundamental basis of investing in stocks. If you are a business owner, the most important thing you think about is the cash – profit – that your company allows you to take home after purchasing inventory and paying salaries. When you own a share of stock, you are an owner of the business, and the same benefit of taking home a profit applies. And just as importantly, corporate profits historically

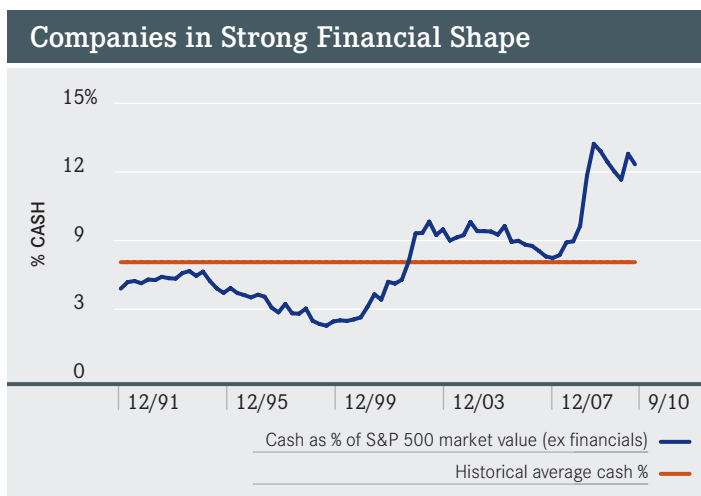
have grown faster than inflation, making equities an effective hedge if and when inflation rises.

Furthermore, over the course of the “lost decade,” companies continued to produce profits and distribute dividends, which should reassure investors that it wasn’t entirely about poor company fundamentals. Indeed, if the forward P/E ratio had stayed the same since the beginning of this century, equity investors would have earned a compound annual growth rate of 5%*, which while below the historical average return for equities of 7%, is still relatively good. And when combined with the equity dividend yield of 1.5% for the period, equity investors would have doubled their investment in the 11 years since the start of the century.

Companies are holding unprecedented amounts of cash. Why is this so important to investors?

You’ve probably heard the saying, “cash is king.” Well, there’s truth to it, particularly as it relates to putting a value on what equities are worth. That cash allows companies to transmit value to shareholders, through dividends or share buybacks, or to make acquisitions that increase the earnings power of the company, and hence additional profits to shareholders. This cash becomes the fuel for corporate growth and profitability in the future.

Right now, after the “Great Recession” and credit crisis that caused companies to hoard cash in fear, companies have unprecedented amounts of cash on their balance sheets (see chart below). We expect that companies will conduct more share buyback programs and increase dividend payout ratios over the next several years, which will return this cash to shareholders.



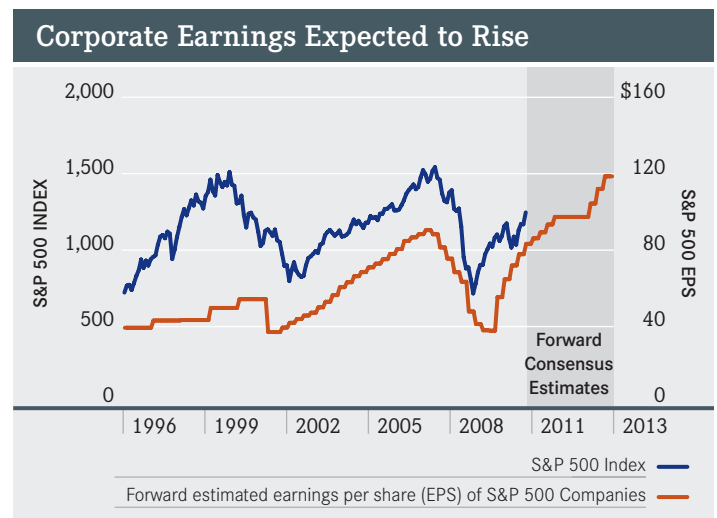
Source: Citi Investment Research.

Arguably, we are already seeing some increase in acquisition activity as companies begin to take advantage of low valuations and high amounts of cash to increase market share or bolster their businesses. Since most acquisitions take place at a premium to the market value of the company being acquired, shareholders theoretically make a profit as well as receive cash. These activities are strong value enhancers for a shareholder of equity, and argue for an allocation to equities.

Stocks have already experienced two years of strong gains. Is there a risk that investors may have missed the opportunity?

I don’t believe so. If you bought equities at the very bottom of the credit crisis two years ago, you took advantage of a once-in-a-generation kind of buying opportunity. While that particular opportunity may have passed, the outlook going forward is still a strong one. The case for equities going forward is about the value, and the growth in that value, that companies will return to shareholders in dividends and buybacks, acquisitions and other methods of value creation. A rise in P/E ratios would only add to the strength of the base case that equities are well positioned to return value to shareholders.

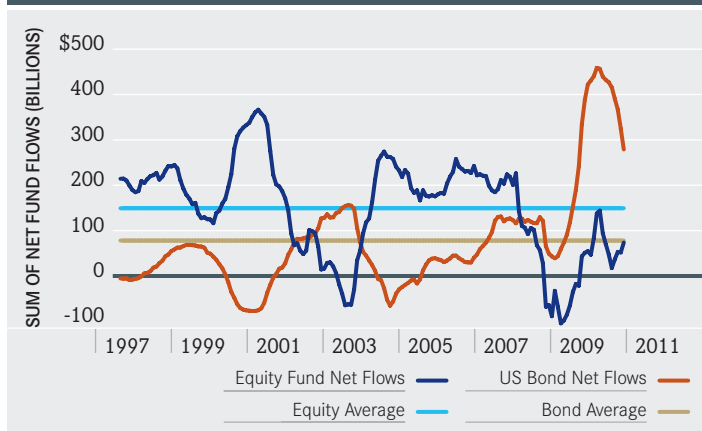
Another way of looking at the upside potential for the value of stocks is to track the estimated earnings for public companies (see chart below). This shows that the earnings expectations for the next couple of years are on a very steep upward trajectory, indicating quite a bit of optimism about corporate performance. And if P/E ratios remain at their current levels or rise, the equity markets should follow suit with strong performance.



Sources: Compustat, IDC via Factset and Goldman Sachs Global ECS Research.

* Includes estimates for 2011 earnings.

Fund Flows Signal Equity Rebound



Sources: Deutsche Bank US Equity Strategy, Investment Company Institute.

Furthermore, we believe equity markets should have additional upside given that fund flows into equities should rise based on pure supply and demand dynamics (see chart above left). Part of this is a result of the spectacular flight to quality out of equities and into fixed income during the credit crisis two years ago. As a result, we believe most investors are currently under-allocated to equities and expect that this increasing demand dynamic should support equity valuations going forward.

Overall, how attractive do you think stocks are compared to alternatives?

Given the discussion of fund flows, it makes sense to compare stocks to bonds as investments. Again, a lot of this comes back to a discussion about cash. Right now, stocks are more attractive as an investment than bonds (see chart above right). I'll expand on that, because stocks and bonds are different instruments from a structural point of view and need to be carefully compared. As you know, stock is ownership in a corporation with no maturity; and a bond is a contractual loan obligation most likely with periodic interest payments, and a maturity date when the original investment is returned to the investor.*

One way of comparing the two instruments is to compare the bond coupon (the stated interest rate paid in cash to the investor) to the free cash flow of a stock (the "true" cash a company makes after making investments and paying salaries). Taking those measures and converting them into percentages makes them easier to compare, which is what you see in the "Stocks Are Attractive" chart – by using the yield to maturity of a bond (the annual interest rate if held to maturity) and the free cash flow yield of a stock (free cash flow as a percent of the stock price).

Stocks Are Attractive Relative to Bonds



Sources: Corporate Reports, Empirical Research Partners Analysis. Capitalization-weighted data.

You can plainly see in the chart that the cash companies are generating is at historical highs relative to US Treasury yields, suggesting equities are extremely attractive relative to bonds. In fact, the free cash flow yield on stocks today is about 6%, fully 250 basis points higher than the yield on US Treasuries, something we've seen very rarely over the past 50 years. In addition, free cash flow can grow, while a bond coupon can't. In our opinion, that's a great reason to own equities.

What is your outlook for inflation and how will that impact equity markets?

Inflation is on the horizon, but when it comes, and to what degree, is impossible to predict. One way investors can protect themselves against inflation is by buying dividend-paying equities, as over the long term, dividends grow faster than inflation. Since profits grow faster than inflation over time as well, and because we believe dividends should continue to increase, equities (and dividend-paying equities in particular) are a strong place to be.

Given your outlook, how should investors think about approaching equity markets?

With cash at historic highs, our view is that companies will likely raise dividend payout ratios over time. We believe companies will put that cash to work for the benefit of shareholders, so we recommend investors start by focusing on dividend-paying companies globally. This equity-oriented income could be used to supplement a traditional bond income allocation in a portfolio. In addition to strong income potential, dividend-paying companies tend to be higher quality and more stable than other companies, a benefit for every investor, not just retirement-oriented investors.

* Stocks and bonds are also different in the capital structure, with bonds holding a senior position to stocks, and for that reason could be considered relatively safer.

Do you have a preference for equities of a particular market capitalization or from a particular region?

I would emphasize large cap multinational companies, which can be headquartered anywhere around the globe. They are very powerful profit generators, and can take advantage of improving economic growth in developed countries and strong secular growth in emerging markets. This exposure to emerging market growth trends allows multinational companies to diversify earnings and potentially grow faster than US-only companies.

Furthermore, it's not coincidental that multinational companies became large and built strong franchises in countries around the world. These companies typically have powerful competitive advantages in the first place, with stronger business models or better products. These competitive advantages typically translate into high returns on capital, allowing them to generate strong free cash flow while they grow. Given these advantages, multinational stocks maintain better margins through challenging economic times, and are impacted less by systemic risk than average stocks.

What additional advice do you have for investors?

Right now the investment thesis is about taking advantage of the long-term returns of equities as an asset class rather than about the strength of one specific sector. As such, my number one view is simply to own equities. Equities have upside potential based on multiple factors, including cash held on balance sheets, the potential for increasing profits, the potential for increased dividend payouts and performance that historically outstrips inflation.

I would also say that investors should seek global multinational companies that pay dividends. The intersection of global multinational and dividends takes advantage of twin drivers: volume growth advantages of global companies with emerging markets exposure, and compelling corporate cash dynamics.

Investors should think about increasing their allocations to equities, as the risks to not being invested in an improving economic environment include the erosion of purchasing power and failing to meet your financial goals.

Investment involves risks. Stock and bond values fluctuate in price so the value of an investment in stocks can go down depending upon market conditions. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investment in emerging/developing markets or smaller capital markets.

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