PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

June 15, 2015

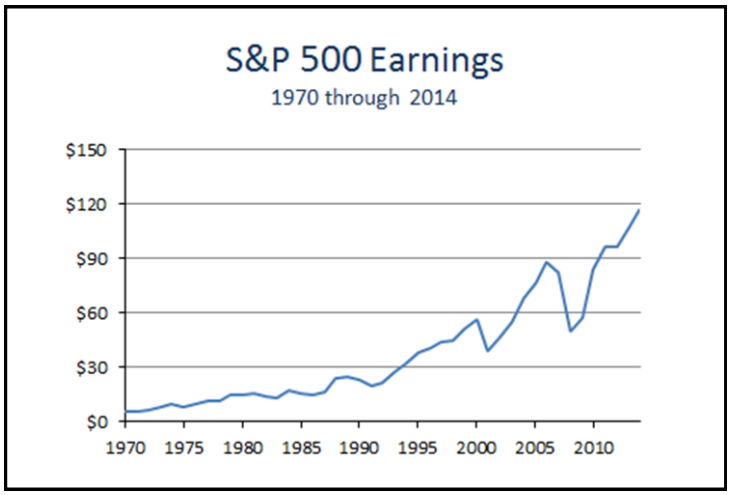
Over extended periods of time, the stock market reflects the underlying growth of the world economies through the earnings growth of the companies operating in those economies. This month, we want to remind investors of the power that long-term earnings growth has on returns.

We acknowledge that total return has three components: earnings growth, dividend yield, and change in valuation levels (P/E ratio). This month, though, we want to focus only on the first component–earnings growth–using three examples to highlight our point.

Remember, for every example, the U.S. economy experienced good times and bad times; plus, since 1970, the S&P 500 has declined by at least 50% on three occasions (1973-74, 2000-02, and 2007-08).

1970 through 2014

The graph below shows earnings growth for the S&P 500 from 1970 through 2014. During this period, earnings were up 20-fold from just under $6 per share to just under $115 per share. This equates to an average annual growth rate of nearly 7%.



During the same period, the price of the S&P 500 went up 22-fold. This price increase is greater than the earnings growth, which means that the P/E ratio did increase. However, the point we want to make is that 90% of the price appreciation was tied to the earnings growth engine.

1997 through2014

In December, 1996, Alan Greenspan, then the head of the Federal Reserve, posed his famous question of how could we determine if *irrational exuberance* existed in the markets and, thus, had unduly escalated asset values. Some investors took this to mean that he thought markets were overvalued. That is not what he said, but markets did sell off for several weeks after his talk.

For those that didn't sell, the earnings engine delivered. Over the next 18 years, earnings for the S&P 500 nearly tripled, meaning they grew at an average annual rate of 6%. The price of the S&P 500 nearly tripled over the same time frame. Again, the earnings engine, and not changing P/E's, fueled returns.

We believe it is important to note that two of the three 50% market declines occurred during this period and the S&P 500 still gained 6% per year before dividends.

2015 through 2045

For multiple reasons, we believe past growth will exceed future growth. In our first two examples, the growth rate of earnings declined from nearly 7% per year to 6% per year.

Looking forward, we believe 5% per year earnings growth is a good starting point. This implies that over the next 30 years, earnings would rise over fourfold. A marginal shrinkage of the P/E ratio over such an extended period of time will reduce the price increase, but a nearly fourfold increase in the S&P 500 could occur over the next 30 years.

We wanted to highlight the logic behind long-term price appreciation and the power that long-term earnings growth has on investment returns. This earnings engine isn't as powerful as it once was, but it should continue to serve long-term investors well.

Tel. 425-213-1600 Fax. 425-213-1610 3740 Carillon Point Kirkland, WA 98033 www.privateasset.com