Capital INVESTMENT SERVICES of America, Inc.

Market Commentary

April, 2013

A Look at Total Return

The total return of any asset is the income it generates plus its change in price, or:

Total Return = Income +/- Change in Price

For a stock or a stock index, dividends represent the income component, or:

Total Return = Dividends +/- Change in Price

Unlike the total return of many other assets – that gold you inherited from your grandfather or that Picasso you found at a rummage sale – stocks are *earning* assets. As such, we can divide a stock's change in price into two subcomponents: earnings growth (or decline) and the change in what investors are willing to pay for it. The second subcomponent is called the Price/Earnings (or P/E) ratio.

Change in Price = (Change in Earnings Growth* + Change in P/E ratio**)

Therefore, a stock's total return is:

Total Return = Dividends +/- (Earnings Growth* + Change in P/E ratio**)

For example, in 2012, the total return of the S&P 500 index was 16% and broke down as follows:

Dividends	=	3%
Earnings Growth*	=	6%
Change in P/E ratio**	=	7%
		16%

If a stock does not pay a dividend, the total return is just the sum of earnings growth and change in P/E ratio.

A Review of the components:

Dividends – Determined by the company's Board of Directors, this is the amount of cash generally paid out of earnings that is not needed to grow the business. Once established, dividend policy tends to be stable over time (i.e., most predictable of the three components).

* Earnings Growth calculated using forward 12-month estimates
** P/E ratio is current price divided by forward 12-month estimates

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Earnings – Are the primary focus of a company's management and likewise are the greatest determinant of the value of a company over time. From earnings, investments are made to grow the business and payout dividends.

Changes in P/E ratio** – The price level investors are willing to pay for each dollar of a company's earnings. This can be based on earnings growth expected in the future, investors' confidence, interest rates, and many other factors.

<u>The Market's Potential</u>:

At the end of the first quarter, the price of the S&P 500 was 1,569 and has risen 10% so far in 2013. Applying the framework discussed above, using consensus assumptions about future earnings for S&P 500 companies, and observing the historical range of P/E ratios**, a range of potential outcomes is possible:

S&P 500 Price:
1,569

		2014 Consensus EPS Est.					
		$113	$114	$115	$116	$117	$118
P/E Ratios	13	1,469	1,482	1,495	1,508	1,521	1,534
	14	1,582	1,596	1,610	1,624	1,638	1,652
	15	1,695	1,710	1,725	1,740	1,755	1,770
	16	1,808	1,824	1,840	1,856	1,872	1,888
	17	1,921	1,938	1,955	1,972	1,989	2,006
	18	2,034	2,052	2,070	2,088	2,106	2,124
	19	2,147	2,166	2,185	2,204	2,223	2,242
	20	2,260	2,280	2,300	2,320	2,340	2,360

		2015 Consensus EPS Est.					
		$121	$122	$123	$124	$125	$126
P/E Ratios	13	1,573	1,586	1,599	1,612	1,625	1,638
	14	1,694	1,708	1,722	1,736	1,750	1,764
	15	1,815	1,830	1,845	1,860	1,875	1,890
	16	1,936	1,952	1,968	1,984	2,000	2,016
	17	2,057	2,074	2,091	2,108	2,125	2,142
	18	2,178	2,196	2,214	2,232	2,250	2,268
	19	2,299	2,318	2,337	2,356	2,375	2,394
	20	2,420	2,440	2,460	2,480	2,500	2,520

		$113	$114	$115	$116	$117	$118
P/E Ratios	13	-6%	-6%	-5%	-4%	-3%	-2%
	14	1%	2%	3%	4%	4%	5%
	15	8%	9%	10%	11%	12%	13%
	16	15%	16%	17%	18%	19%	20%
	17	22%	24%	25%	26%	27%	28%
	18	30%	31%	32%	33%	34%	35%
	19	37%	38%	39%	40%	42%	43%
	20	44%	45%	47%	48%	49%	50%

		$121	$122	$123	$124	$125	$126
P/E Ratios	13	0%	1%	2%	3%	4%	4%
	14	8%	9%	10%	11%	12%	12%
	15	16%	17%	18%	19%	20%	20%
	16	23%	24%	25%	26%	27%	28%
	17	31%	32%	33%	34%	35%	37%
	18	39%	40%	41%	42%	43%	45%
	19	47%	48%	49%	50%	51%	53%
	20	54%	56%	57%	58%	59%	61%

The median historical P/E ratio** for the S&P 500 over the last 15 years is 16 and consensus earnings estimates for 2014 (which will be the 12-month forward EPS at the end of 2013) and 2015 of $115 and $123, respectively, (the highlighted results) suggest the S&P 500 could appreciate another 18% by the end of 2013 and 27% by the end of 2014.

**P/E ratio is current price divided by forward 12-month estimates

Add dividends of about 2.5% for 2013 to the estimated price change of 27% (10% YTD and 17% potential) and the total return for 2013 could be almost 30%. For the rest of 2013 and through all of 2014 the total return could be close to 40%.

It is important to remember that these calculations are dependent on assumptions. However, they do provide a helpful framework in evaluating the market's potential.

We remain focused on understanding the current trends in fundamentals because it gives us the best probability for success.

For more information on this or any other topic of interest, feel free to contact us.