



The Rennie Quarterly Return

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What is a stock really worth?

In these days of stock market turmoil, there is every reason for investors to shun stocks in favor of less volatile investments.

And why not? The stock market is responsible for the precipitous decline in investment account balances, postponed retirement, and perhaps worst of all the curtailment of the time-honored company holiday party. Stocks are pilloried in every avenue of mass media. A local radio station that provides an LA traffic update every five minutes now augments that with a stock market report. Traffic is bad enough without the sudden realization that you will be sitting in it four more years than planned!

In light of the above it is easy to forget what stocks are and what they should be worth.

The history of stocks

The first to issue a stock was the Dutch East India Company in 1606. At the time, the cost of merchant sailing vessels was such that only a government or nobility could underwrite construction. By issuing shares of "common ownership," pooling of financial resources to construct ships could be achieved for the first time. This development led to rapid fleet growth.

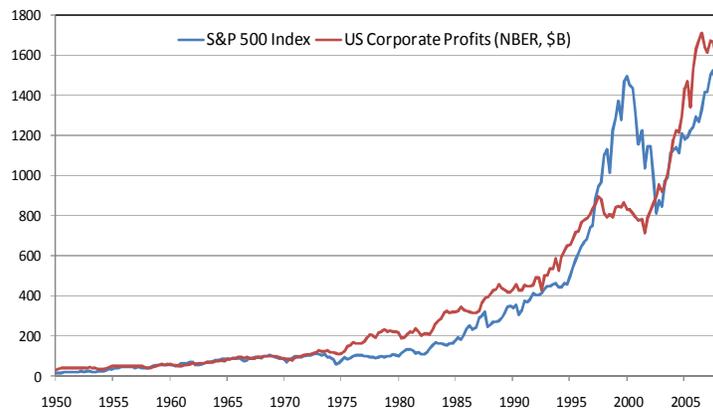
Fast forward to 1792 when 24 brokers signed the Buttonwood Agreement

outside 68 Wall Street in New York thus forming the New York Stock Exchange.

In the intervening period and all times since, a share of common stock has represented a share of ownership in a company; a share of every machine, every product, and most important, a share of the profits.

Evidence

This truism is borne out by the historical relationship between



corporate earnings and stock prices. As shown in the graph, stock prices have followed corporate profits closely over time. The largest divergence was during the '98-'00 technology bubble when stock prices clearly got ahead of corporate earnings and subsequently corrected.

In the last year, the graph implies that stock prices have diverged in the opposite direction, falling more than corporate profits. This may

imply we are due for a recovery. But read on.

What is a stock worth?

In spite of recent market events, a common stock continues to entitle the owner to a share of company profits. Thus, a stock's value is directly related to the future profits of the company.

Many models exist to determine the fair price of a stock. However, an estimate of future earnings (dividends can

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Our Two



"This is the lesson: never give in, never give in, never, never, never - in nothing, great or small, large or petty - never give in except to convictions of honor and good sense. Never yield to force; never yield to the apparently overwhelming might of the enemy."

Sir Winston Churchill, to students of Harrow School, October 29 1941



Quarterly Trivia:

What is the symptom of chrematophobia?

fear of money

sometimes be a useful surrogate) is always the key input. Unfortunately, no one knows for sure what profits will be. Every investor and analyst has an opinion. That is why one investor may see a stock's price as a bargain, while another would rather sell. When the two get together, a trade occurs. A price gets reported.

In the long term, the one with the most accurate earnings forecast will be handsomely rewarded.