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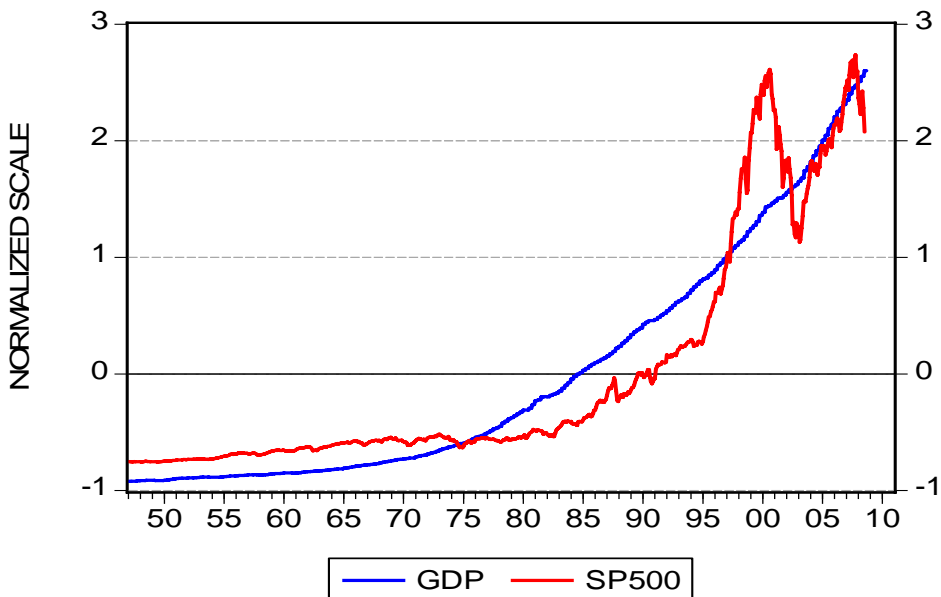
## Why do we buy stocks?

- Equity market action this past week showed some improvement. Although we believe it is too early to declare a bottom, sentiment indicators are at very pessimistic levels which are often a precursor to an improving market. The S&P 500 held psychological support at 1200 which also tends to be a good sign.
- Equity markets have been volatile over the past several months, buffeted by a series of problems. The financial system has come under significant stress as credit problems increase solvency worries. The economy has markedly slowed, suggesting we are in, or almost in, a recession. Investors have been concerned that policy actions taken to support the economy and the credit markets will eventually be inflationary. This has led to a sharp rise in commodity prices.
- As equities are affected by these adverse trends, fear levels have increased. Thus, we feel it is a worthwhile exercise to review the rationale for owning stocks.
- Equities give the holder an ownership stake. Warren Buffett suggests that when you buy a stock, you want to take the attitude of an owner. Think of it this way; you are converting your savings, gained by consuming less than your income, into an investment that should, hopefully, become worth more in the future. Thus, a prudent investor in an individual stock should try to understand “everything” about the business—its management, industry, regulatory environment, etc.
- One of the primary benefits we believe society gains by having widespread public ownership is the ability to easily diversify one’s equity investments. After all, there will likely always be a “knowledge deficit” between the management of the firm and its public owners. Having more than one equity issue in a portfolio tends to offset that deficit.
- However, in our opinion, there is also another important factor that comes with broad ownership of equities. In effect, an investor is participating in the long-term economic growth of the nation. Essentially, companies tend to be more profitable when economic growth is solid, inflation is under control, the regulatory environment is favorable, etc. Positive economic conditions that support profitability tend to also benefit stock prices. Although an individual stock tends to be more affected by the individual fundamental factors surrounding that company, a broad stock portfolio is also like owning a piece of the overall economy.
- In this week’s Chart of the Week, we examine the relationship between the economy and equities.

*Bill O’Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.*

## Chart of the Week:

### GDP AND THE S&P 500



*For illustrative purposes only. This does not reflect the performance of any specific investment.  
Past performance is no guarantee of future results*

Sources: Commerce Department, Haver Analytics, Wachovia Securities

This chart overlays the S&P 500 with nominal (non-inflation adjusted) gross domestic product (GDP) from 1947 to the present. We have used a normalization process to better illustrate how the two series track each other. As the chart indicates, an expanding economy and rising equity prices tend to move together. There are periods of apparent under and overperformance of equities to the economy. Since we are using nominal GDP, these divergences tend to be tied to long-term investor expectations about inflation. For example, the relative underperformance from 1975 to 1995 appears to be tied to the actual inflation problems in the 1970s and concerns over a return of inflation in later years. Our research suggests equity investors tend to develop their inflation expectations over a decade. However, it is important to note that even with these inflation concerns, equity prices still tended to track the overall growth of the economy.

We believe the bottom line is this—over the long run, a broad portfolio of equities is really a position designed to capture the long-term growth trend of the economy. Long-term equity investors should not lose their focus on this assumption during periods of turbulence.

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