KOBREN
INSIGHT MANAGEMENT
An E*TRADE Wealth Management Company

Letter From The Portfolio Manager

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What Worries Us


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Key Points

- *There are plenty of reasons why investors remain cautious and defensive regarding the stock market.*
- *While many of these concerns have some merit, some of them don't deserve the emphasis that they are getting.*
- *We remain upbeat on the market's prospects, though we discuss some potential catalysts that could change this view.*

"How can one possibly be positive on the stock market?"

This is easily the most common question we get these days. Quite frankly, it's been the most common question for some time. Nonetheless, as we enter the New Year, we have maintained our optimistic outlook. This doesn't mean we don't have concerns (we always do), or we don't recognize that the market could falter (it always could), but it does mean we believe that most factors, and more importantly the more critical factors, net out to retaining an optimistic outlook.

So, what does worry us? In this letter, we will survey the laundry list of risk factors that we consider important and what it would take for us to change our market view.

What Does – Or Could – Concern Us?

"We don't have to be smarter than the rest. We have to be more disciplined than the rest."
Warren Buffett

At Kobren Insight Management (KIM), we have historically derived our stock market outlook through monthly updates of our "Equity Five Factor Model," which can be found at www.kobreninsightmanagement.com. In the model, we always examine the same five factors; while we are always searching for better inputs for the model, the key is to regularly collect the same data, study it for its historical relevance, and then discuss what the current reading might mean for future stock market direction. If the model is suggesting a more optimistic outlook on stocks, as it is now, our outlook and client portfolios will reflect that reading.

Valuations are one of the five factors in our model, and arguably the most important factor in determining how we position client portfolios at KIM. Currently, many bearish investors and commentators are citing how expensive the market is, especially if they are using trailing earnings; technically, they are correct. Using the last four quarters of reported earnings through the last completed earnings season (3Q09), the S&P 500's price/earnings (P/E) ratio is at 86x (!) – well above the long-term averages which are closer to 20x. Using reported earnings through the end of 2009 (as of this writing, 60% of the 4Q09 earnings season is complete), the P/E ratio for the S&P 500 drops to 22x. While this is a more reasonable valuation, it still suggests that the market is expensive.

While we generally have a preference for using historical earnings over expected forward earnings, this is an example of a time in market history when we believe the use of historical earnings is likely to give a very bad read. In short, earnings in the 4Q08, and to a much lesser extent the quarters directly surrounding it, were extraordinarily abnormal due to the financial panic that started in late 2008. Thus, instead of looking at trailing earnings, one should use expected reported earnings for 2010 to get a better sense of the market's true valuation. Doing this reveals a P/E of 18x (and using operating earnings instead of reported earnings further decreases the P/E to 14x). *Bottom line, using forward earnings suggests that the market is not expensive.* And this doesn't even take into account that when inflation and interest rates are low, which they currently are, valuations tend to be above the long-term averages.

In addition, it is important to note if valuations are rising or falling. If they are rising, investors are increasingly paying more for each unit of value as their risk appetites grow. Valuations have risen for the past year, and continue to do so presently; we view this as a positive.

So, how could valuations concern us? They will concern us when they are at above-average levels, falling, or both. However, this is not currently the case.

Yet, in the near term, we think that **earnings** are an even more supportive factor for the stock market than valuations. Despite concerns from many that a recovery has not begun, or that a double-dip (i.e., recovery quickly reverts back to recession) may occur, it should be noted that corporate reported earnings are expected to grow by nearly 20% in 2010 (the long-term average for earnings growth is 6%). However, despite those seemingly optimistic expectations, we think the greater risk is that these estimates might be too low, not too high.

The reason behind this thinking is that the magnitude of the rebounds coming out of recessions is typically related to how severe the preceding economic contraction was. In other words, the higher a ball is dropped from, the higher it will bounce. Historically, after severe economic contractions, GDP growth has averaged +7% in the 12 months following the economic trough. Currently, despite the very sharp and very clear V-shape on most economic data series, the consensus expectation for GDP growth in 2010 is still below 3% – this is smaller relative to the long-term averages and well below the typical rebound after a sharp contraction. In short, market participants are slow to adjust their expectations higher, and we think that the upcoming adjustment period – where expectations will continue to play catch-up with real improvement – is likely to provide a tailwind for the stock market.

The current earnings season, as of this writing, is proceeding admirably. According to the BeSpoke Investment Group, nearly three quarters of the companies that have already reported earnings have beaten expectations; this is one of the best "beat rates" in a dozen years. Additionally, guidance for future quarters is running strongly positive, with this positive guidance outweighing negative guidance by nearly four to one; similar to the beat rate, this is the best guidance ratio of the past decade. And, analysts' earnings expectations continue to improve. We expect that this will continue as expected reported earnings growth for 2010 is still 30% below the 2007 trailing four quarters earnings peaks, and expected earnings in 2011 are expected to be 20% below the 2007 peaks. Remarkable.

When does the corporate earnings picture start to concern us? When earnings start to disappoint and decelerate. Once again, however, this is not currently the case.

The interest rate environment remains supportive of the stock market. Their absolute level, as well as the recent trend of government interest rates, is clearly supportive. Another strong positive is that credit spreads (the yield difference between non-Treasury bonds and Treasury bonds) continue to tighten, revealing that risk appetites are expanding again. Yet another positive signal coming from the bond markets is that the yield curve (the difference in yields between short maturity bonds and long maturity bonds) is very steep; typically, a steep curve is a leading indicator of a stronger economy and market.

When will the interest rate picture start to concern us? The big concern for us is when rates start to *significantly* rise and stick at much higher levels, especially if this rate rise occurs in corporate bonds. With the economy getting stronger, and the Federal Reserve apparently holding short-term rates at low levels for the foreseeable future, the interest rate environment seems likely to be stock market friendly for some time.

Investor sentiment is another key variable that we watch. If most investors are bullish and have invested according to this view, we will become concerned. The reason is two-fold; first, if investors have already committed their capital, then how much buying power remains to push the market higher? Second, if everybody is bullish, then good news will likely be expected and factored into market prices. Unexpected bad news, however, could create a market reversal.

Right now, however, when looking at what investors are saying and doing, we are still seeing investor sentiment as being too negative. While investor sentiment surveys are only slightly negative (though we haven't talked to many of those who are bullish of late!), actual investment allocations are still defensive, and cash levels remain very high. Last year was also a record year for inflows into fixed income funds, and despite one of the better years ever for the stock market, flows into domestic equity funds were actually negative. If "everybody is bullish" is really true, then they certainly have a funny way of showing it. Once investors really do reach a consistently bullish extreme in sentiment and allocations, investor sentiment will finally start to make us nervous.

Speaking of cash, there are other **liquidity** (i.e., supply/demand) factors that we monitor for the five factor model. They are also mostly positive at present, including our expectation that M&A activity will increase. However, one item that concerns us is the slowing growth in money supply, specifically in M2. The M2 measure, which is a broad classification for money capturing currency, checking accounts, savings deposits and money market accounts (excluding institutional accounts), is often a leading indicator of economic and market activity. Though still positive, it has recently fallen to below-average levels. This is something we will monitor going forward.

Yes, But What About…

Outside of the five factors that we monitor, there are clearly numerous factors which have put many investors ill at ease with the stock market's potential this year. We think there is legitimacy to some of these factors, although we think some of the concerns are overemphasized. We will address some of those concerns in "Research Perspectives".

One of those concerns is that **"this time is different."** As the late Sir John Templeton said though, these are the four most expensive words in investing. Is this time really different – just like it supposedly was for permanently high stock market valuations a decade ago, the Great Moderation earlier this decade due to sophisticated financial innovation and enlightened central banking, or the thought from several years ago that residential real estate prices could never go lower?

Will future market returns really not be impacted by starting valuations? Will earnings growth no longer be relevant? Will interest rates no longer impact markets? Will the investment biases clearly articulated in behavioral finance be refuted and rejected? Are consumers and markets no longer resilient? Will innovation no longer happen? While each market era has its own unique qualities, it is hard to imagine that this era is truly so different that the basic drivers of stock market returns will no longer function.

Sincerely,

Rusty Vanneman, CFA, CMT

Chief Investment Officer

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