
LETTER FROM THE PORTFOLIO MANAGERS

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Bad Words



Eric M. Kobren

Bear Market.

Recession.

These are not the words that equity investors want to hear, but these days it's what we are all hearing nonetheless. With stock prices moving lower, energy prices seeming to rise every day, and with corporate earnings in the dumps, it's understandable that negativity is ruling the day.



Rusty Vanneman

What Is a Bear Market?

Now that we have added to the number of times the phrase bear market has been cited, what actually defines a bear market? The most common definition is a market at least 20% off its recent highs. By that definition, the Dow and the Nasdaq are already in a bear market and the S&P 500 is a hairs breadth away (down 19%). Some market followers argue that you should simply be out of stocks during a bear market. While obviously one would like to avoid losses, once a bear market has actually been confirmed, most of the damage has typically already been done. Looking at bear markets going back to the 1940s, once it has been officially established, a bear market is already on average two-thirds over, whether one is looking at the magnitude of losses or the duration of the downturn.

For the long-term investor, even if the current situation matches the historical template, this doesn't mean one should postpone purchases or sell outright. If anything, this is a time to accumulate positions. To quote famous investor, Bernard Baruch once again: "Don't try to buy at the bottom and sell at the top. It can't be done except by liars."

When will the market find its footing again? No one can say, definitively. But what we can say is that a lot of the factors we look at suggest the market could do fairly well in the second half of the year. However, a six-month market outlook is not our primary focus. The center of our attention is to seek to maximize your returns given an appropriate level of risk.

As the saying goes, it's a marathon, not a sprint. While we don't know what the market will do in the coming weeks or months, we do believe that the global economy will continue to prosper in the years and decades ahead – and we want to participate. Besides, with the U.S. stock market already off its peak levels by approximately 20%, that means stocks are on sale. As portfolio manager Chris Davis (of Selected American) has said: "You make most of your money in a bear market; you just don't realize it at the time."

Continued ...

What About Recessions?

Currently more than a few economists are claiming that the U.S. is already in a recession, though one has not yet been officially declared. If the economy is weak, that must mean that stocks will struggle, right? Not necessarily. Over the last ten recessions, in fact, the stock market has risen six times (for an average gain of 1.4%). The reason stocks can rise during periods of outright economic contraction is that stocks are, as you have heard us say many times before, a discounting mechanism. They are already onto the next thing, even if the current economic data in the news is bad.

The unofficial and oft-quoted definition of a recession is two consecutive quarters of negative real GDP growth. Actually though, the official arbiter of recessions, the Business-Cycle Dating Committee of the National Bureau of Economic Research defines them as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.” Most important, recessions are not usually declared by the committee until at least several months after they have begun (or sometimes even after they are already over!)

The average length of the past 10 recessions was 10 months, and the two most recent, (1990 and 2001) have only been 8 months long. In other words, as with a bear market, once a recession has been identified, it’s probably closer to its ending than its beginning. We have one last comment on this. The average gain for the stock market the first six months after a recession has ended (again looking at the last 10 recessions) has been +11%.

We have just cited the “historical averages” for how the stock market behaves during bear markets and recessions. The problem with averages, however, is that each individual economic and market situation has its own unique considerations. Could the current environment be worse than past bear markets? There are compelling arguments to support that view. The thing is, there are also compelling arguments for the current environment to be better.

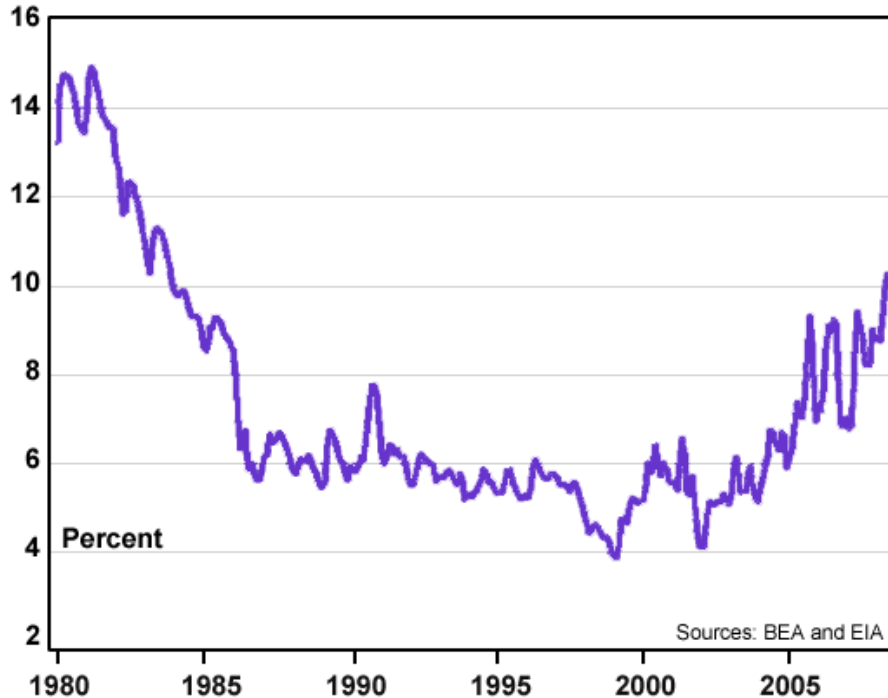
Energy Prices May Come Down (at least in the short-run)

We talk to a lot of smart people. What is the unanimous view on energy? There isn’t one. Some talk about why crude oil can go to \$200 a barrel and others talk about how energy prices also have the potential to plummet quickly. Both arguments seem plausible.

The rise in energy prices has hurt. There is no debating that point. The chart on the following page shows how the price of gasoline takes a larger share of our disposable income than in years’ past (though not as high as the early 1980s experience).

Typically, however, the cure for high prices is ... high prices. As we all learned in Economics 101, higher prices tend to reduce demand and also create incentives for producers to increase supplies, which in turn should cause prices to move lower.

1,000 Gallons of Gas as a Percent of Per-Capita Disposable Income January 1980 - May 2008



On the first count, demand has definitely been negatively impacted. For starters, the growth of world oil demand has actually **slowed** for four consecutive years. In the U.S., year-over-year demand actually **declined** in 2007 and energy consumption has declined this year. In sum, it would seem that higher prices have indeed reduced demand. As for supply, that is debatable. Some argue we are at absolute peak oil production already and no amount of price increases will result in higher production, while others claim that new technologies will yet expand production. In any case, as yet, there is no convincing evidence that higher energy prices have caused a significant increase in energy supply.

Other factors that have contributed to the increase in oil prices include the decline in the dollar and demand from non-traditional investors. Regarding the dollar, higher commodity prices tend to be highly correlated with a lower dollar, and vice versa. With the trade-weighted U.S. dollar now at its most undervalued level in decades, it would seem to be difficult for a value-oriented investor to remain bearish on the U.S. dollar with any real conviction, at least in the near-term. A stronger dollar would provide a stiff headwind for energy prices to continue higher.

As for interest from non-traditional energy investors, there has been strong demand in recent years from investors (not necessarily “speculators” such as hedge funds, etc.) who are seeking to diversify into other asset classes outside of conventional equities (the S&P has only returned an annualized 2.9% for the past 10 years). This additional demand has pushed up prices. This is, however, a technical factor, not a fundamental factor. Over the long-term, fundamental factors trump technical factors. Once stocks begin to recover or commodities start to falter, or a combi-

nation of both, we believe it is unlikely that these investors will stay committed to commodities - a diversifying asset class that is still seen as non-traditional.

Earnings Growth Should Improve

Even though real GDP hasn't turned negative yet (if it will at all), we have in fact already seen negative corporate earnings growth for the last three quarters and we expect to see a fourth consecutive quarter of negative earnings growth for the second quarter of 2008. This is a big reason the S&P is now down 13% over the last 12 months.

This will be the 14th time since the mid-1940s that there will be four consecutive quarters of negative earnings growth. Look at what the market does afterwards – above average returns the next quarter, the next six months, and the next year. The reason is related to a comment we made earlier – recessions typically last just about a year.

S&P Performance After 4 Consecutive Quarters of Earnings Declines			
Date	Next Quarter	Next 6 Months	Next Year
6/30/1944	-1.85	2.31	14.56
6/30/1946	-18.83	-16.98	-17.47
12/31/1951	2.52	5.01	11.78
3/31/1957	7.39	-3.83	-4.56
9/30/1958	10.29	10.75	13.62
9/30/1970	9.43	19.12	16.78
9/30/1975	7.54	22.53	25.48
12/31/1982	8.76	19.53	17.27
12/31/1985	13.07	18.72	14.62
6/30/1990	-14.52	-7.76	3.67
9/30/1991	7.54	4.08	7.72
9/30/1998	20.87	26.49	26.13
9/28/2001	10.29	10.23	-21.68
6/30/2008	?	?	?
Average	4.81	8.48	8.3
Median	7.54	10.23	13.62
All Periods	1.95	3.93	8.21

Source: Bespoke

Maintain Your Discipline

In closing, even though we see plenty of encouraging signs, we don't know when the market will find its footing again. Nobody does. What we do know, is that prices will eventually move higher, and buying stocks now at lower prices is an advantage for long-term investors. Investing for the long-term isn't easy. It can be a real test. As we mentioned earlier in this report, investing is like a marathon. And bear markets can be like Heartbreak Hill in the Boston Marathon. And the best strategy for attacking the "heartbreak hills" of investing is to maintain your discipline.

Sincerely,



Eric M. Kobren
President
Portfolio Manager



Rusty Vanneman, CFA
Director of Research
Co-Portfolio Manager