
LETTER FROM THE PORTFOLIO MANAGER

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Mid-Year Outlook: Stock Rally in the Late Innings?



Rusty Vanneman

On June 5th, 2009, the economist and author Peter Bernstein passed away. Bernstein was one of the great investment professionals of the modern era. Not only was he accomplished in the practical aspects of investing, but also in his ability to explain with simplicity, theoretical aspects of investing to both his professional peers and the public. Professionally, this may have been his greatest gift.

Many of the obituaries on Bernstein, when they discussed his professional achievements, emphasized that he was a proponent of efficient market theory (which suggests the markets are coolly rational and informationally efficient). Personally, I feel that this emphasis was misplaced, as I believe his major contribution rested more directly with the theory of portfolio management, including the need to diversify and manage risk.

Bernstein had many notable sayings. Here is one I saved from earlier in the decade in an attempt to defend balanced portfolios against the common demand of the time – many investors wanting all-equity portfolios. Now, of course, we are arguing against all-bond portfolios!

“Your future wealth isn’t a game. ...Investment management provides only one dependable way to survive through the uncertainty of the future: diversification. Diversification means owning assets that do not move up and down together — a portfolio destined to subdue volatility rather than to maximize returns, while still exposing you to the widest possible range of positive opportunities. (A colleague once suggested you are never adequately diversified unless you have some holdings that make you uncomfortable.) ...I propose restoring the 60/40 to its rightful place as the center of gravity of asset allocation for long-term investors. “

-- Peter Bernstein Bloomberg Personal Finance Jan/Feb 2002

I saved this comment for its various nuggets of wisdom. Not only did Bernstein address the uncertainty of the future (always a good reminder), he stated that the best practice for long-term investors dealing with an uncertain future is to maintain balanced, diversified portfolios. His proposal that the classic balanced portfolio of 60% stocks and 40% bonds/cash as the center of gravity for asset allocation is also a crucial point. We also believe that this is a good starting point for many investors though, of course, asset allocations should be modified depending on each investor’s unique situation. These factors include investment objective, time horizon, and risk tolerance as well as market outlook.

Thank you Peter. May you rest in peace.

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Can The Rally Continue?

Peace, however, is not something that the markets have provided for investors thus far in 2009. Despite an overall price return of approximately 2% for the S&P 500 at mid-year, the index started the year with a 25% loss before rebounding 36% by the end of June. Never mind these dramatic multi-month moves, the intra-day, daily and weekly price moves have also been quite dramatic. In short, given the strong economic cross-currents still in place, we expect that the markets will remain bumpy in the months ahead with plenty of big swings. Peace will remain in short supply.

This volatility has kept many investors on edge and disbelieving of the market's recent gains. The question on everybody's mind: "Can the rally continue?" is usually quickly answered with a skeptical response. In fact, most investors remain quite bearish and defensive.

We like to consider ourselves skeptics as well, and despite the S&P's best calendar quarter in over a decade, our outlook for the stock market remains mostly positive. It isn't so much that we are raging bulls – market prices and valuations are up substantially off the lows from March – we just think there are solid reasons to not be negative. Even though a short-term market correction would not surprise us, we do not think the rally is in its last innings. In this report, we'll explain why. We will also explain our thinking on a few key market exposures that have shaped the positioning of our portfolios. This includes international markets, larger-capitalized domestic stocks, as well as corporate bonds in the fixed income world.

Corporate Earnings

Earnings expectations have improved in recent months. Operating earnings are now expected to improve 12% in 2009, while reported earnings growth are now projected to nearly double the 2008 numbers. While the absolute level of corporate earnings is still at levels from 2002/2003, the trend has clearly improved.

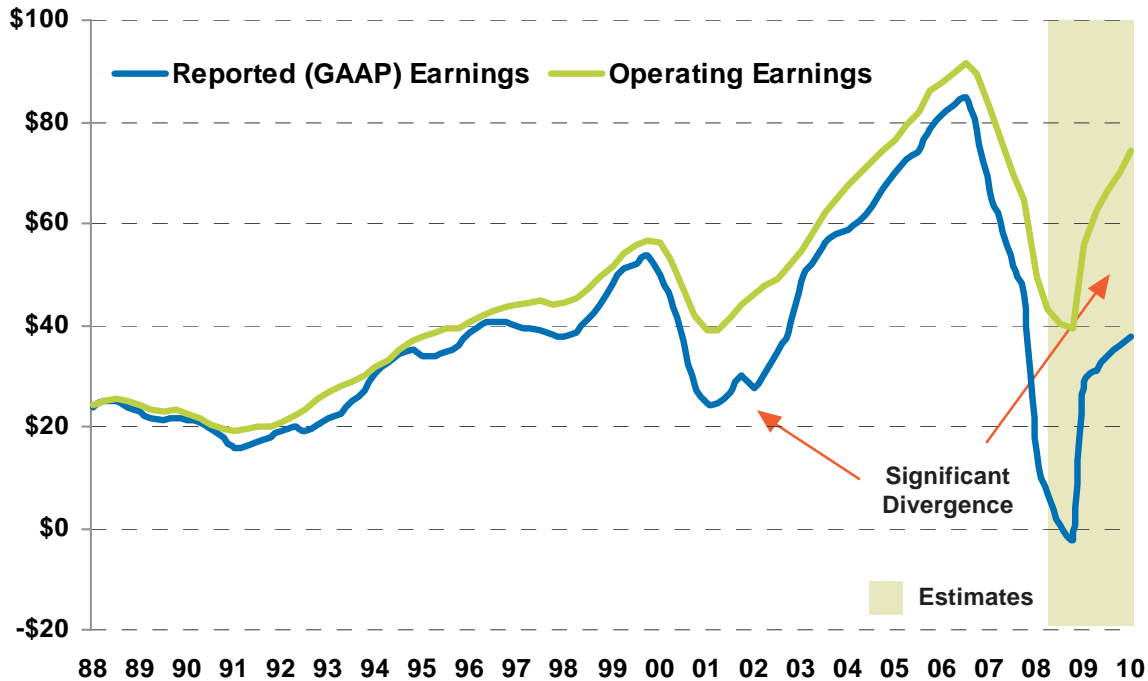
We see an interesting conflict in corporate earnings which we think may be another indication of an economic trough. Currently, there is a large divergence between reported earnings and operating earnings. Generally, these two earnings measures move closely together (reported earnings are usually about 90% of operating earnings), but they have a tendency to diverge during recessionary periods. (One reason is that corporate executives often pile on negative extraordinary charges during market environments where expectations are already bad.) The good news is that such divergences in the past have usually been resolved by reported earnings "catching up" with operating earnings.

The chart (next page) highlights two key points we just made: (1) earnings expectations are improving, and (2) the dramatic divergence between reported and operating earnings.

In addition to the points made above, there is still a strong possibility that earnings could even be better than the consensus expects. Analysts tend to be too optimistic regarding their earnings projections, but this is not usually the case around economic troughs. If the economy is exiting a trough, then the actual path of earnings on the chart (next page) a year from now could look even more dramatic than it does now.

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S&P 500 Earnings — Rolling 4 Quarters



Source: Kobren Insight Management, Standard & Poor's

Valuations

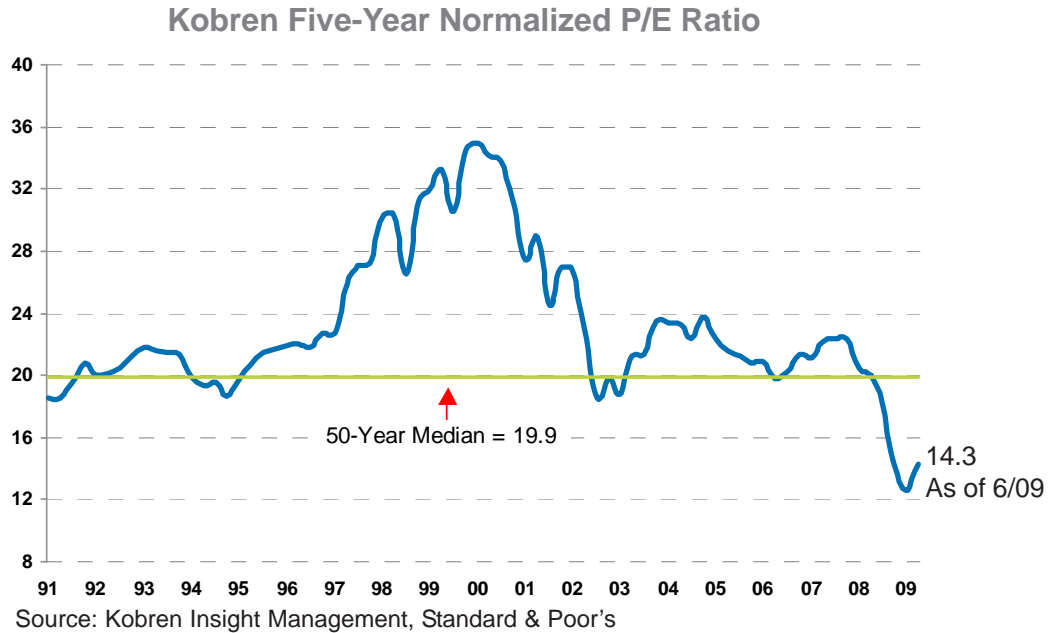
On balance, valuations remain mostly attractive. Let's look at the price/earnings (P/E) ratio, which is arguably the most common valuation metric used.

There are various ways of computing a P/E ratio. Some use operating earnings while others use reported earnings. Some use historical earnings, or expected earnings. Some use a year's worth of earnings data; some use multiple years' worth of earnings to "normalize" earnings. This is why one might see vastly different P/E ratios at the same time for the same market. It depends on the analyst and how they compute the ratio.

Our preference is to normalize the earnings number. We feel that this provides more reliable and smoother input in forming an opinion about whether or not the market is attractively priced. A good reason for this is that P/Es often provide vastly distorted signals at economic inflection points. For example, when corporate earnings are weak, P/Es are often elevated as the denominator is depressed. This would suggest that the market is expensive, when actually it may be an excellent time to increase exposure to stocks since an economic recovery appears imminent. Conversely, when corporate earnings are peaking, P/E ratios may be lower as the denominator is now inflated. Again, this may suggest that the market is cheap, but in actuality, it may be expensive. In short, normalizing earnings takes care of most of these issues by looking at earnings over an economic cycle.

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Currently, the normalized P/E ratio is approximately 15 times earnings. This is well off the multiple of just over 10 times back in early March, but it is also well below the 50-year median multiple of roughly 20 times. If the stock market was able to get back to its longer-term median – admittedly, this usually takes years to do – this would take the stock market back (assuming no earnings growth) to approximately the level the market was at before selloff that began last September.



Before moving on, there are a couple of more questions about valuations, which we often receive, that need to be addressed. First, what is a “fair” long-term multiple for earnings? Debates have been waged and papers have been published on this topic, with no decisive answer. In general though, there is some consensus about what conditions are needed for valuations to be higher or lower. For instance, when there is price stability in the economy (in other words no significant inflation or deflation), valuation multiples are higher. Second, when costs are lower – transaction costs, taxes, or the even the costs of attaining quality information – valuations tend to be higher as well. Related to both of these points about inflation and costs, is the level of interest rates. When rates are low in an absolute sense, then valuations again tend to be higher.

So, where do we stand today? While there are clear threats to price stability, costs, and interest rates – then again, there always are – in an absolute sense, current conditions would suggest valuations should be higher than long-term averages, not lower.

Second, how effective are valuations in forecasting stock market returns over a variety of time frames? While we have often stated that valuations are a powerful driver of returns over periods of 10 years or so, they do appear to have some predictive power for time frames as brief as a year. In sum, when valuations appear cheap on an historical basis, the market tends to produce above-average returns over time frames of 1-year, 3-years, 5-years and 10-years. And, when valuations appear expensive, the market tends to produce below-average returns over the same time frames.

Sentiment

Typically after market rallies, investor sentiment follows; this has not been the case so far this year, which is encouraging. Perhaps the rally could still have legs. As the late Sir John Templeton said: “bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.” It could be argued that the current emotional backdrop for the market is still pessimistic, skeptical at best.

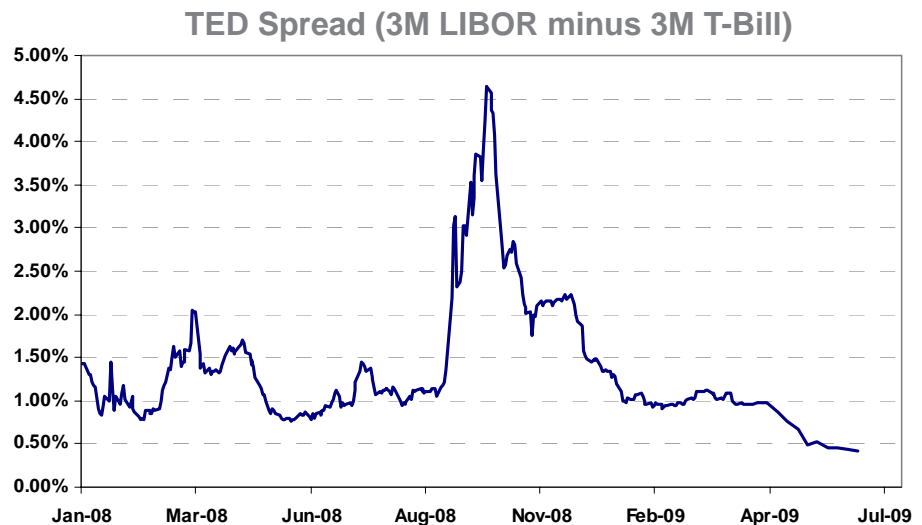
At the end of the quarter investor sentiment was registering excessive pessimism. Excessive pessimism is defined as over-all sentiment being at least one standard deviation below the long-term average. Historically, when sentiment is this negative, the market tends to produce above-average returns in the following 3-, 6-, and 12-months.

Sentiment isn't just about what investors say, it's also what they do. Perhaps an even more powerful signal is that money is finally emerging from cash accounts and moving back into the markets. We don't have data for June yet, but the month of May witnessed the largest monthly inflow into mutual funds ever. Is the tide starting to turn? If so, it may be useful to remember that there is still a tremendous amount of cash still on the sidelines, potentially representing a considerable amount of buying power that may eventually want higher returns than what is currently being earned on short-term money.

Liquidity

Speaking of money flows and liquidity, this picture remains mostly positive as well. When we assess liquidity – which generally means we are attempting to assess supply and demand in the marketplace – we look at a variety of indicators, ranging from monetary policy to the technical condition of the market. Inter-market relationships also provide an indication of overall market liquidity.

One inter-market relationship we have often written about is the TED Spread. The TED Spread is the difference between interest rates on inter-bank loans (LIBOR) and short-term U.S. government debt (Treasury Bills). A higher level for the TED Spread suggests that liquidity conditions are tight while a lower level suggests more normal conditions.



As can be seen by the chart (previous page), the TED Spread has continually improved all year and is now back at levels before the panic-induced sell-off from the Lehman bankruptcy back in September 2008. The current level of approximately 0.4% is even below the 15-year average of 0.6%. This would suggest the liquidity conditions have improved enough to temper concerns about credit risk; in turn, this should continue to restore the demand for riskier assets.

Given the points above, matched with positive second half of the year seasonal factors and a supportive interest rate environment, it would appear the stock market has the potential to extend its second quarter gains into the second half of 2009.

Now, what market areas should be emphasized?

International

International markets continue to generate a lot of investor interest, and for good reason. Not only do non-U.S. economies, in the aggregate, appear to offer higher economic growth potential, but they also had a great first half of the year in terms of price returns.

Despite the strong absolute and relative gains in international markets last quarter, we are maintaining (and in some cases even modestly increasing) exposure to international markets. This view is driven by relative valuations. The easy story at present, as it has been for awhile, is Asia (outside Japan), but it's important to remember that Europe and Japan make up approximately 75% of the non-U.S. stock market – and they are cheap.

Currently, Europe (ex-U.K.) and Japan are sporting relative valuations compared to the U.S. that are similar to earlier in the decade before international markets began a pronounced multi-year run of significant outperformance versus the U.S.

To re-state, investing in international markets is not just about the emerging markets and the Asian story, it is about all international markets. So, how much should investors have in international investments? In our opinion, a good rule of thumb regarding over-all portfolio exposure levels to the international markets for a U.S. based investor is approximately 20%. This includes both international stocks and bonds. This 20% investment weight approximates the amount the average American consumer spends on non-dollar goods and services. Investors should have at least this much exposure to international.

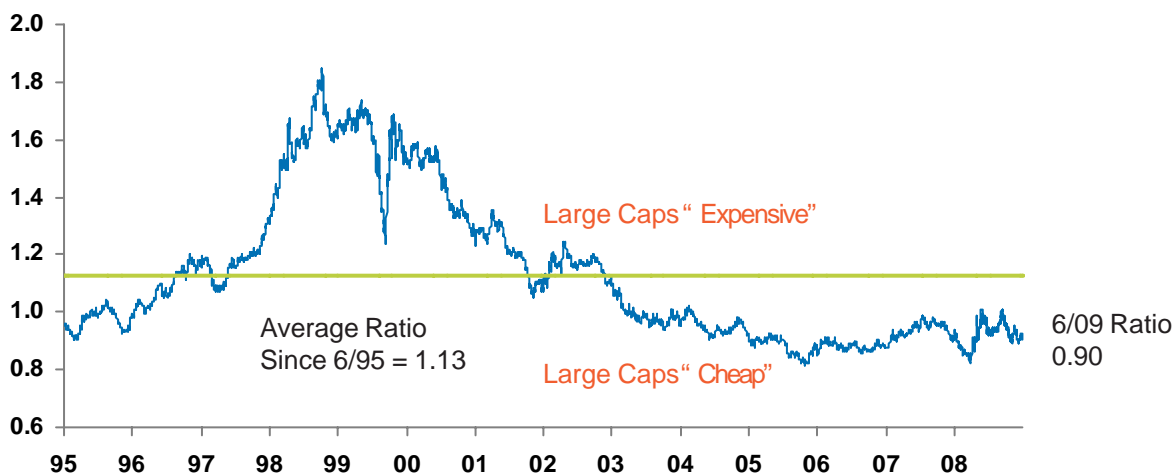
Large Caps

When it comes to domestic stocks, we have been advocating increased exposure to large cap domestic stocks for several years. As the chart (next page) shows, we have had some satisfaction with that view, but not as much as we would have guessed – especially given the markets over the last few years. Nonetheless, we are maintaining that view.

There is a combination of reasons we prefer larger companies, beyond the appearance that large caps appear to be 25% undervalued to smaller companies by referencing the relative price performance over nearly the last 15 years.

Our primary attraction to larger companies is due to relative valuations. Using data from The Leuthold Group that goes back to 1973, small cap stocks typically trade at roughly a 15% discount to larger companies. Currently, however, they trade at a small premium. In other words, larger companies appear even cheaper than smaller companies do.

Russell Top 200 Index (Large Cap) / Russell 2000 Index (Small Cap)



Source: Russell, Kobren Insight Management

Yet another reason we are attracted to larger companies is that they are under-appreciated and under-owned. As a frame of reference, large capitalization stocks make up over 70% of the stock market in terms of total stock market capitalization. Most investors have less, sometimes significantly less, exposure than that, though. This was not only the case coming into the year, but looking at fund flows through the end of May, large cap funds have had by far the largest outflows of the year – well over 90%.

We do recognize and appreciate the leading argument for small cap stocks is that they tend to do better in market and economic recoveries. It's hard to argue against that since this is regularly the case. That said, small caps tend to lead in recoveries because they significantly lagged during the preceding market and economic weakness, thus their starting valuations are often depressed relative to larger companies once the rally begins. That's not the case right now. Despite historic weakness in the markets of 2008, small caps did not significantly underperform as would have been expected versus larger companies in such an environment.

Lastly, in an environment where overall economic growth may be lower than historical averages (due to consumer deleveraging and more government regulation), it seems intuitive that larger companies

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with more stable earnings, larger compliance resources, and bigger lobbying budgets are also more likely to outperform.

Corporate Bonds

Coming into the year, we stated a strong preference for corporate bonds, both investment grade and high yield. Both segments have done well so far in 2009, especially the latter. Investor interest in corporates has also exploded with much of the aforementioned record flows into mutual funds going into fixed-income funds.

Because of the strong gains this year, our enthusiasm is dampened. Still, we are retaining our current positioning. Spreads between investment grade corporate bonds and Treasuries, as well as spreads between high yield bonds and Treasuries, remain well above long-term averages. While we think there is a strong possibility that most of the “easy gains” are now behind us and the road ahead will be choppy, valuations still suggest that corporate bonds deserve a healthy weighting in client portfolios. And, while the concern that corporate high yield bond price gains “have gone too far, too fast” has become a popular refrain, the historical evidence actually shows something else. The asset class actually tends to generate above-average returns in the following 3-, 6- and 12-months (at least double the long-term average in each time frame) *after* especially strong quarters.

How much should one have in corporate bonds? For an approximate frame of reference, the overall taxable bond market is roughly 25% corporate bonds (including high yield). We believe that investors should have at least this much exposure, with about half of the over-all corporate bond exposure in high yield bonds.

Summary

While valuations are no longer as attractive as they were a few months ago, we are maintaining our optimistic outlook. Though the stock market has had a nice run in recent months, an argument can be made that the rally can continue in the second half of the year. We also recognize that the markets are likely to remain volatile and thus uncomfortable. But as Peter Bernstein himself said, the only way to take advantage of future positive opportunities – which will appear as they always do – is to remain committed to a balanced, diversified portfolio.

Sincerely,



Rusty Vanneman, CFA, CMT
Chief Investment Officer
Portfolio Manager