
Letter From The Portfolio Manager

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Still Climbing The Wall Of Worry

And Other "On The Wall" Observations



Rusty Vanneman

The wall next to my desk is, as they say, an "information-rich" environment, featuring a dizzying array of charts, tables, and notes of various sorts. (Mostly) constructive criticism from clients typically finds some wall space. Of course, being a parent, handmade art from my children (Come Home Dad!) has a prominent place, as well.

One constant among this disparate collage of information, is a list of somewhat unusual and thought-provoking statistics that I keep positioned right at eye-level:

- 82% of people say they are among the safest 30% of drivers
- 80% of students think they will graduate in the top half of their class
- 19% of people believe they are among the richest 1% of U.S. households

As a professional, these statistics serve to constantly remind me that it is very easy to become overconfident. While having a *slightly* overconfident view of one's capabilities can often be beneficial when it comes to daily living, it tends to work against us when it comes to investment decisions. For individual investors, overconfidence can lead to unhealthy investor behavior in a variety of ways, from extending into areas beyond their circle of competence, to excessive portfolio trading, or extreme portfolio concentration.

The drive to "outsmart" everyone else feeds into this misperception of one's investment acumen. The reality, however, is that lasting success is mainly due to factors of temperament and adherence to classic investment principles, as opposed to raw intelligence and mastering vast amounts of trivial data. An effective way to offset the behavioral tendency to be overconfident is to maintain a balanced, diversified portfolio that is appropriate for your own unique situation.

Overconfidence is bred in a variety of ways, but one common scenario occurs when the consensus of opinion leans strongly in one direction. There is comfort in numbers, comfort in being part of the crowd. The problem, however, is that (almost by definition) consensus thinking tends to lag, not lead, the market. Current opinion is typically shaped through the news media's attempts to explain recent (i.e. *past*) market action. Opinion is framed by what was: The markets reward what will be.

Climbing The Wall Of Worry

Currently, investor sentiment remains strongly negative. As is typically the case in the explosive early stages of extended market rallies, the stock market seems to be climbing the proverbial "Wall of Worry" as many investors remain skeptical of the recent gains. In fact, according to the American Association of Individual Investors (AAII) sentiment survey taken with only a few days left in May, the percentage of individual investors with a negative outlook for the stock market over the next six months was nearly

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50%! This is the most bearish investors have been since early March when the rally began. This level also ranks among the top 5% bearish sentiment readings since the beginning of the AAI survey data back in the late 1980s.

Though a popular view, this extremely defensive market sentiment actually suggests that enterprising investors should have an optimistic outlook for the next twelve months. Studies of investor sentiment by Ned Davis Research show that when investors are excessively bearish, the stock market typically generates an above-average return over the next twelve months. Conversely, when investors are displaying excessive optimism, the market tends to produce a negative return over the ensuing year. When investors are neutral, the market produces below-average, though positive, returns. In short, when the majority of investors agree with your outlook, rather than being confident and comfortable, you should be wary and questioning.

There is one more interesting item about current sentiment. While the level of investors negative on the market is clearly elevated, the number of investors positive on the market is basically at the long-term average, the difference is that level of investors who say they are neutral on market direction is near its lowest level ever. Given this sharp polarization in market outlooks, we expect that volatility in the stock market will remain elevated.

Stay the Course

This said, our own outlook is not as favorable as it was three months ago. The market is no longer very cheap, as it appeared to be in early March. It is no longer vastly oversold. Earnings estimates and guidance are no longer being relentlessly hammered down.

In addition, the dollar is falling and interest rates on long-term Treasuries are rising. Such behavior in these markets is typically not considered to be stock-market-friendly. I believe this behavior is driven less from a returning appetite for risk, than from a dissipating appetite for safety. U.S. Treasuries and the U.S. dollar are often seen as safe havens during times of extreme market stress. The “flight-to-safety” trade that dominated 2008 appears to be in the process of unwinding.

Regarding corporate earnings, we remain in the camp that growth for 2009 is going to be fairly positive on a year-over-year basis. However, we still have plenty of concerns about this view. One interesting item from the economic data released late in May was embedded in the University of Michigan Consumer Confidence data. Even though confidence surprised sharply to the upside – and over-all consumer confidence is often a leading indicator of consumer spending – there was one notable item that concerned us. Expectations for income growth (+0.2%) are the lowest they have been in the history of the survey, dating back to 1948. It seems hard to reconcile that view with the notion that consumer spending will return to anywhere near the levels it did earlier in the decade. It also puts a pinprick in the balloon of rising inflation fears that seems to be on the mind of many investors.

In forming a long-term view of the market, valuations are critical. While short-term market calls based on valuations are dicey, over periods such as ten years, stock market returns have a strong

connection to what valuations were at the beginning of the period. Though valuations are still fairly attractive, the 40% rally in the S&P 500 off the March 6th intra-day lows has squeezed some juice out of future return expectations. The normalized price/earnings ratio was just above 10 in early March (its lowest level since 1982), but at the end of May it was quickly approaching 15. While this is still approximately 25% below the 50-year average, it's simply not as attractive as it was a few months ago.

Given this mixed bag of disparate market factors, what should investors do? As you can probably guess by now, our counsel is the same as our antidote to overconfidence: stay the course with a balanced, diversified portfolio appropriate for your situation. There are always cross-currents swirling in the economy and markets. If you are in the market, stay in. If you are currently out of the market, we recommend that you set up a plan to become involved.

Set It and Forget It?

For the most part, this entire article has been a roundabout way to answer the most common question we get these days: "Is buy and hold investing dead?" (Some now derisively refer to that strategy as "buy and hope.")

That depends on how you define "buy and hold." Does buy and hold mean having a long-term investment plan? Does it mean finding and maintaining a strategic mix of assets that has the right balance of growth potential and portfolio stability to accomplish your specific objectives? Does it mean controlling portfolio activity to minimize both direct and indirect costs?

To me these are key attributes of long-term — otherwise known as buy and hold — investing. These attributes have worked well in the past and I believe they will continue to work well in the future.

The problem with the concept of "buy and hold" is really the word "hold." One shouldn't simply "set it and forget it," as Ron Popeil used to say in his infomercials. Being a long-term investor does not mean buying something and then never monitoring the position again, or not correcting or adjusting a situation where action may be required. Instead, a successful long-term investment approach should be called something more along the lines of "plan, invest, monitor and adjust." Not quite as succinct, as "buy and hold," but something I think worthy of putting up on my wall, nonetheless.

Sincerely,



Rusty Vanneman, CFA, CMT
Chief Investment Officer
Portfolio Manager