
LETTER FROM THE PORTFOLIO MANAGERS

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Stay the Course



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The S&P 500's total return for the first two months of 2008 was the worst start for the stock market index since 1941. Only one start was worse than 1941 and that was 1933. Corporate earnings and liquidity concerns are still weighing heavily on the market.

It's been a hard stretch of time for all investors. While the Kobren portfolios have held up well relative to the S&P 500 Index on a total return and risk-adjusted basis, they have still lost ground. Since we eat our own cooking, we've lost ground too. Market action over the last few months has hit all of our pocketbooks and doesn't make anyone feel good.



Rusty Vanneman

That said, there are plenty of reasons to be optimistic about the market's long-term prospects. We touched upon some of these factors in last month's report, including valuations. To re-state, some valuation metrics look better for the stock market now than they have at any time over the past 10-15 years. As you have surely heard us say before, valuations may be a poor short-term predictor of market direction, but they do a pretty good job with the long term forecasts.

In this month's commentary, we'll review a few items. First, we'll take a look at some of the recent changes in the corporate earnings environment. It is pretty fascinating and it has something for everybody. Then, we'll segue into our latest thoughts on investing in international securities.

Corporate Earnings – The Bad News

Corporate earnings for the fourth quarter continue to disappoint. The shortfall relative to expectations has been large enough that earnings for the entire year of 2007 are now negative whether one is looking at operating or reported earnings.

Looking at operating earnings, year over year earnings growth is now expected to be down 6%. Looking at reported earnings, however, the year-over growth is now expected to be down 19%.

Not only are the actual fourth quarter earnings coming in below expectations, but expectations for 2008 earnings have been reduced as well. The change over the last two months in expectations for 2008 reported earnings growth has been reduced by 15%. In short, this movement in earnings and earnings expectations has clearly been a heavy stone for the market to carry.

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Before we proceed, what again is the difference between “reported” and “operating” earnings? In short, reported earnings are the **broadest measure of corporate performance**. Operating earnings are the **earnings from a company’s principal operations**.

Corporate Earnings – The Good News

There are two ways to look at the data which suggest some hope moving forward. One has been mentioned often in the press, but we think it’s the least important of the two. The second one may sound too simplistic, but it can actually move markets and move them in a big way.

First, it has been mentioned that the earnings losses have not been broad-based, and that’s true. Only two sectors have seen year-over-year earnings growth shortfalls in 2007. One sector is consumer discretionary, which is down 15%. The other sector is financials, which is down 34%. For a frame of reference, the median earnings growth gain for a sector in 2007 was +5%. Not all sectors shared in the earnings losses.

To us, however, a more compelling argument moving forward is that earnings growth may appear stronger later this year. It’s not necessarily because the numbers later this year will be so much higher, but because the numbers we are seeing in the current quarter will be lower. As we often say — because it is what the market often reacts to — the “trend is more important than the level.” Never mind what the actual level of earnings is, an expected 7% gain in earnings growth in 2008 is definitely better than a 7% earnings decline (this is exactly the movement we have seen in expected reported earnings growth for 2008 over the last month). With earnings being reduced now, they will have an easier hurdle to beat in the quarters ahead. That sort of movement in earnings is what the market often seizes upon.

International Investing – Tactical Assessment

Over each of the last six calendar years, developed international stock markets have done better than U.S. stocks. Over each of the last seven calendar years, emerging international stock markets have done better than U.S. stocks. Over the last five years, through February 29th, U.S. stocks are up 12% a year; developed international markets are up 18% a year and emerging markets are up about 33% a year. It’s time to buy more international, right?

Not necessarily. There is one big difference now from the start of the decade and that is relative valuations. At the start of the decade, valuations were much lower for international markets. That is simply not the case now.

Currently, Europe vs. the U.S. is basically trading at its 20-year relative valuation average. Asia ex-Japan is well above its 20-year average and relative valuations are now back at levels last seen in the mid-1990s – right before years of underperformance.

Just look at the table below. This table contains the calendar year returns for the S&P 500 (a proxy for U.S. stock market returns), the MSCI EAFE Index (a proxy for non-U.S., developed international stock markets in dollar terms) and the MSCI Emerging Markets Index (in dollar terms):

	S&P 500 TR	MSCI EAFE USD	MSCI EM USD
1990	-3.10	-24.71	-13.55
1991	30.47	10.19	55.68
1992	7.62	-13.89	9.03
1993	10.08	30.49	71.66
1994	1.32	6.24	-8.72
1995	37.58	9.42	-6.91
1996	22.96	4.40	3.93
1997	33.36	0.24	-13.45
1998	28.58	18.23	-27.67
1999	21.04	25.27	64.09
2000	-9.10	-15.21	-31.90
2001	-11.89	-22.61	-4.68
2002	-22.10	-17.52	-7.97
2003	28.68	35.28	51.59
2004	10.88	17.59	22.45
2005	4.91	10.86	30.31
2006	15.79	23.47	29.18
2007	5.49	8.62	36.48

Emerging markets are not trading at the fat discounts that they were from just a handful of years ago. By some measures, emerging markets are now trading at premiums. Granted, emerging markets have higher expected economic growth, are running large current account balances, and appear to be more stable than they have been in the past, but they don't have the valuation support they once did.

Refer to the above chart again. About five years ago, relative valuations between the U.S. and emerging markets showed the emerging markets were extremely cheap relative to the U.S. Look at the performance of the emerging markets since then. Emerging markets have crushed U.S. stocks. Thing is, emerging-market relative valuations are now back at mid-90s levels. Look at how emerging markets performed after that. Okay, moving forward, what do you think the probabilities favor in

terms of relative performance? Before you answer, there is one other thing to remember: Most market comments are really rationalizations and follow market performance. Valuations, however, often precede stock movement.

To be fair, one region that does look cheap right now is Japan. In sum, though, this is probably not the ideal time to overweight international.

International Investing – Strategic Importance

Despite our concerns about the international markets short-term, investing in international securities remains a critically important part of building balanced, diversified portfolios.

With over half of the world's stock market capitalization in non-U.S. stocks, it's clear that the investment portfolio's "opportunity set" doesn't have to be contained to just U.S. stocks. First, a broader opportunity set offers more chances to enhance returns. Second, because international economies are not completely in sync with the U.S. market, there are diversification benefits to be gained by investing in foreign markets. Given this lack of perfect correlation, there are oppor-

tunities to reduce the over-all volatility of an investment portfolio over time. In sum, adding international investments to a portfolio should increase risk-adjusted performance over time. You have heard us say that before. One big question remains, however, and that is, what is the “neutral” weight for investing internationally? In other words, how much of an investor’s portfolio should be in foreign currencies?

There are a lot of ways to attack this question. Various investment professionals have different answers. Some like to use portfolio optimization tools that incorporate either historical or expected return and risk characteristics. These sorts of tools can be extremely important and useful – if they are used properly.

First, they are great educational devices because they get to the bones of what building diversified portfolios is about. Second, they can be great selling tools because the story and data are often so compelling.

Nonetheless, they are still flawed. One reason is that the inputs used for future return and risk expectations are often historical returns and risks. This often leads to a fancier form of “performance-chasing.” One way around this is to provide subjective forward-looking inputs. In many ways, this is better than using historical inputs, but it also has a couple of problems. First, nobody really knows the future! These subjective inputs can be highly informed and educated forecasts perhaps, but they are still forecasts in uncertain conditions. Second, output from these tools is highly sensitive to the inputs. In other words, a slight change in inputs can cause a big change in outputs.

In sum, optimization tools are powerful tools within the industry with valid – but limited – applications. Our brief comments above only skim the vast body of work on this topic. Another approach is to simply look at the entire global market. International markets make up over 50% of the global market’s capitalization now. As a result, some suggest that U.S. portfolios should replicate the global market.

In our experience though, this won’t work. It won’t work because investors have a “home bias.” In other words, their real benchmark tends to be a domestic benchmark, not a global one. The S&P 500 tends to be that benchmark. Despite some flaws, it’s the benchmark most investors see on TV. It’s the benchmark they read about. It’s the benchmark that their friends and family tend to reference as well.

Adding international when it’s doing well is easy to do, but history has shown that investors abandon international once it starts to underperform the S&P 500. Remember that one of the key features of a diversified portfolio is that it enables an investor to “stay the course.” Adding too much international, however, runs the risk investors won’t hang onto the portfolio.

Okay, let’s get to an academic argument that we think makes sense. The real risk in international investing is the currency exposure. It’s not opportunity cost, but the risk of losing purchasing

power. Currently, looking at GDP data over the last 10 years, the typical American is spending just a bit over 20% of their income on imported goods. This is the currency exposure. So, to have neutral currency risk, the typical American investor should have about 20% of their portfolio in non-dollar assets. Of course one could reduce currency exposure through using international funds that hedge their currency exposure, but currently few funds actually do so.

Summary

In sum, the market is struggling right now as companies continue to write down earnings. There is a silver lining in this, however, as lower earnings now mean easier comparisons to beat later. Many investors presently think that escaping the U.S. market and investing heavily in international markets is the way to go, but we don't necessarily agree. While we think international securities belong in a well-diversified portfolio, too much can endanger an investor's ability to stay the course.

In the end, that's our best advice. Stay the course. Despite its near-term problems, we believe that the economy will continue to prosper in the years and decades ahead and valuations haven't looked better since the early to mid-1990s. For the long-term investor, this is a better time to buy than to sell the stock market.

Sincerely,



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