
Letter From The Portfolio Manager

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Is It Really Different This Time?



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“The four most expensive words in the English language are ‘this time it’s different.’”
Sir John Templeton

The markets are painful. They have been for awhile. The conventional view is that the economy and markets will remain under pressure for some time, perhaps even for a few more years. It’s hard to argue against the consensus given the current balance of headlines, economic data points, and market losses.

The fear is primarily driven by a view that this recession is darkly different than past recessions and that this bear market will necessarily have to be deeper as a result. While there is some truth that there are some disturbing differences between this cycle and past ones, it’s useful to remember that the stock market can ascend even if economic growth is stagnant or contracting. It’s also useful to remember that recessions and bear markets **always end** – and usually much more quickly and definitively than most anticipate.

Remember When?

It’s also useful to remember how quickly the conventional view is proven wrong. Let’s review some of the major conventional views in recent years – all of which were supported by headlines, economic data points and market action at the time:

- In 2008 inflation was a top concern as commodity prices and official inflation data were rising and in some cases were rising sharply. Now, deflation concerns dominate.
- Also heading into 2008, the consensus view was that the global economy and markets had “decoupled”. In other words, if the U.S. economy and markets suffered, the international markets, especially emerging markets, would not suffer nearly as much – if at all. Last year, however, international markets, especially emerging markets, lost significantly more than the U.S.
- Going back to 2007, consumer confidence was at historically high levels and it was hard for many to believe that consumers would retrench. Now, less than a year and a half later, consumer confidence has plummeted to new lows.
- Also into 2007, “liquidity” was the leading reason why the stock market would keep going higher, even with those investors who acknowledged that valuations were too high. Needless to say, months later, a historically severe “liquidity crisis” took hold.
- Also up until 2007, even though fixed income credit spreads (i.e., the difference in yields between government bonds and non-government bonds such as corporate bonds) were trading near multi-year

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extremely tight spreads (i.e. expensive), it was widely considered that non-government fixed income was attractive given how low Treasury yields were and how stable the economy was. In 2008, however, high yield bonds were down 26% while long-term Treasuries were up 23%.

- Even into 2007, over-all stock market volatility was at historic lows for a few years and it was widely believed that, thanks to enlightened central bank policy and the innovative new ways to manage risk through financial market securitization, this was likely to persist for many years. In 2008, however, we just lived through the sharpest market volatility in 70 years. In fact, volatility quadrupled from levels just a few years before.
- The common view up until a few years ago was that housing prices could not go down, and if they did they wouldn't be down much or for very long. House prices did peak in 2006 and are now off nearly 30% from peak levels.

Each of these views had plenty of economic and media support at the time. Each also had satisfaction in that the markets continued to confirm those views, at least for a period of time. Each, however, proved to be significantly wrong, and proved to be wrong a lot more quickly than people expected. Current views on the economy – as solid as they may seem right now – could end up equally wrong.

Bear Markets Do End

Even though the strong consensus view is for more losses ahead, two key points should be remembered. First, stocks typically rebound in advance of an economic recovery. As we have frequently written, “stock markets often climb a wall of worry” meaning that stock market prices often rise in the face of negative news and investor doubt. The second item to remember is that every bear market is eventually followed by a bull market, and those bull markets are often bigger than many investors expect.

A recent study by Fidelity Investments reminds investors who flee to cash during bear markets about the potential cost of missing the early stages of a market recovery. Historically, the very early stages of market recoveries have provided the largest percentage of returns per time invested.

Examining the last 14 bull markets going back to 1930, each tend to have one thing in common: front-loaded performance. For example, the first month of a bull market produces an average return of 14%, which comprises on average 12% of the entire bull market performance. The first three months produce an average of return of 18%, which comprises on average just under 20% of the entire bull market.

The key conclusions of the Fidelity study are that by definition new bull markets are not known until after the market has gained 20%. Investors who move completely out of stocks during bear market declines (defined as 20% drop in price) may want to re-consider doing so given how powerful gains typically are off market bottoms coupled with the difficulty of finding the exact bottom. As the saying goes, no bell will ring on the day of the market bottom.

Triumph of the Optimists

One of the more outstanding investment books is called “Triumph of the Optimists” (Princeton University Press, 2002), which was written by Elroy Dimson, Paul Marsh, and Mike Staunton. The data for the book, which examines capital markets returns from 17 different countries going back to 1900, was recently updated. The data should be reassuring for the long-term investor.

Since 1900, the United State’s stock market, **after inflation**, returned about 6% a year. Government bonds beat inflation by 2% a year and Treasury bills (short-term) beat inflation by 1%. Inflation during this time averaged roughly 3% a year.

Over the last 50 years, which obviously incorporates the dismal performance of the current decade, stocks still beat bonds by approximately 2% a year on average and bills by nearly 4%.

The United States has been one of the best performing markets over the last century plus. It is reasonable to assume that the experience may not be as strong moving forward. As such, capital market returns for the world minus the U.S. are a bit lower. Since 1900, stocks, after inflation, have been up just under 5% a year, while government bonds and bills each beat inflation by approximately 1% a year. Inflation for the world, ex-U.S. also averaged about 3% a year.

What does all this data mean? In short, **despite all the economic, political, and cultural volatility and turmoil of the last 100 years or so, stocks still produced the best long-term returns.** There is no reason to think that won’t continue moving forward.

Valuations Suggest Above-Average Returns

The numbers above don’t even factor in valuations. If valuations are considered to be low, which they are now, then return expectations should be increased.

To be fair, valuations typically have minimal impact in explaining capital market return over extremely long-term time periods. They are also typically poor predictors of short-term term performance. Where they are strong is in helping predict performance over time periods such as a decade or so. And now, valuations are low, hinting that returns over the next decade could even be better than the long-term averages cited above.

There are many ways to look at valuations. Perhaps the most popular is the price to earnings ratio, otherwise known as the “P/E Ratio”. Price/earning ratios are computed in different ways. At KIM, we like to look at a “normalized” price/earnings ratio. Normalization means to adjust earnings to minimize the cyclical impact of the economy’s ups and downs. It is argued that this creates a smoother and ultimately more effective valuation measure. We also like to look at five years of data (four years of historical operating earnings data plus one year of forecasted operating earnings).

In the last week of February, and using official S&P data through the end of last month, the normalized P/E dropped to 11x. This is the lowest the 5-year normalized P/E has been since July 1984 (for

the record — the 10-year annualized return 10 years after that date in 1994 was nearly +16%). This P/E is also 45% undervalued to its 50-year average P/E of 20x. This P/E ranks among the lowest decile of P/Es over the last 50 years using this metric (lowest 17% of all P/Es going back to 1871).

Some like to adjust the P/Es for other factors. There's an argument to do so. First, some like to adjust P/Es by inflation rates. In short, P/Es tend to be higher in environments where inflation tends to be fairly average (around 3%/year) and stable. Conversely, P/Es tend to be lower in deflationary environments or when inflation is rising rapidly. Interestingly, the historical five-year inflation rate is actually quite average at present, which suggests that P/Es should be well **above**-average, not below. The twist, of course, is that there are strong deflationary and inflationary cross-currents at present. This situation bears monitoring.

Others suggest that P/Es should be adjusted by changes in tax rates, regulatory policy, interest rates and transaction costs. All else being equal, P/Es should be lower if any of the above increase. Currently, it could be reasonably anticipated that most of these factors are more likely to increase in the years ahead than decrease.

Question Grab Bag

In the remaining space for this month's commentary, we are going to provide a quick answer to some of the many questions we have received in recent weeks. We'll keep it brief here, but please feel free to contact us if you'd like more detail:

Q: Valuations may seem fine, but aren't earnings getting crushed?

A: Corporate earnings were indeed decimated in the fourth quarter of 2008 and guidance for 2009 earnings growth has also been significantly lowered. Nonetheless, there are positives. First, earnings revisions are not getting worse. Second, earnings house cleaning was massive enough that the impact of extraordinary items should be fairly minimal in the first half of 2009. Lastly, and perhaps more importantly, despite the lower guidance for 2009, earnings growth – whether one looks at reported or operating earnings growth - -is expected to be over +20% in 2009. The stock market should like that.

Q: Won't high unemployment keep the economy and markets down?

A: The unemployment rate has historically been a lagging economic indicator while the stock market tends to be a leading indicator of economic activity. In fact, according to data from Ned Davis Research going back to WWII, when unemployment is above 6%, the stock market tends to gain 13% over the next 12 months. When unemployment is between 4.3% and 6.0%, the stock market's average gain per year drops to about 5%. When unemployment is below 4.3%, the stock market return has been about 2% per year.

Q: GDP was sharply down last quarter and is likely to be down in the quarters ahead. Fed Chairman Bernanke and even Warren Buffett think the economy will struggle this year. Stocks can't rally in the face of that, right?

A: The stock market typically leads the economy. Just look at recent history. Stocks peaked in the fourth quarter of 2007 and are now down over 50% from all-time peaks then. Nominal GDP meanwhile, reached its all-time peak in the third quarter of 2008 and is now down about only 1%. Real (i.e., adjusted for inflation) GDP peaked in the second quarter of 2008 and is now down only about 2%. ***In short, GDP does not need to move higher for stock prices to rise.***

Q: Won't massive government spending hurt the economy more than it will help?

A: Most likely no – and yes. First, as for the first half of our answer, the government has the ability to spend money when the rest of the economy is not spending as much. In short, the government has the ability to potentially stabilize, or at least minimize economic losses to some extent, in the short term. Longer term, however, government spending – which is typically related to higher taxes — is generally not considered as optimal as private spending. A study by Rob Arnott, the chairman and founder of the firm Research Affiliates, did a regression study where a 1% increase in the tax burden as a percentage of GDP had a nearly one-for-one downward impact on GDP, and only about 10 cents on the dollar of the higher taxes actually made it to the government.

Q: Won't the American consumer be down and out for a long time?

A: This is an important question as the answer will shape the economy in the years ahead. Savings rates are back on the rise and consumer debt levels are dropping. This is good for the long-term health of the economy. Nonetheless, will we go back to the savings rates of past generations? Has the 24/7 world of constant real-time information and opinion transformed our culture in any way? Do families still play Monopoly, or do they now just play Wii? In short, in a world of internet shopping and quick and easy cash-less transactions, it seems unlikely that consumer debt levels and saving rates are likely to go back to prior generation levels.

Q: Should I be more concerned about deflation or inflation?

A: This may be one of the more critical issues to monitor in the months and years ahead. There are clearly some major deflationary factors in place right now, but given the massive increase in money supply in recent months, it would be quite reasonable to see higher inflation – perhaps even significantly so – in the years ahead. If inflation did in fact significantly uptick, this could take a bit of the starch out of the long-term valuation argument. Again, this is something to closely monitor.

Q: Does investment decision-making change given the government's increased role in the economy?

A: This is another good question, and clearly deserves more than a one paragraph answer. Given that the government's role in the economy is likely to expand, the short answer is that the rhetoric and policy out of Washington will indeed be a bigger factor in driving market performance. Nonetheless, when it comes to the stock market, the basic rules of investment success of buying companies with growing earnings at good prices remain.

Q: Could the market continue to extend to new lows?

A: Even if the market is cheap and oversold, it can, of course, continue to move to new lows and get even cheaper and more oversold.

Q: What should an investor do if the market goes to new lows?

A: If one has a balanced, diversified portfolio with a long-term value orientation, the bias should be to buy market weakness.

Q: Are you personally investing in the stock market?

A: Absolutely.

What to Do Now

As we have talked about before, there are two elements of investing. First, there is the rational side of investing. In this report, we reviewed multiple items, including long-term market history, expected earnings growth, as well as the current valuations of the market. It appears to be a great time to buy. Emotionally, however, it's not so easy. All of us can appreciate that.

If you are currently in cash, or have positioned your portfolio quite conservatively given your long-term objectives and risk tolerance, you may have avoided a lot of the market damage. Now might be a good time to start wading back into the market. One way to do so is to set up a plan and stick to the plan. One approach could be to dollar-cost average over three equal installments. Put one third of the assets into a balanced, diversified portfolio now, another third in three months, and the remaining third in another three months after that. The key is to maintain discipline through thick and thin.

If currently invested in a balanced, diversified portfolio, there's a good chance you haven't re-balanced your portfolio in quite some time. This might be a good time to re-balance your portfolio back to target weights. For current KIM clients, we will be periodically rebalancing for you.

If currently invested, but nervous, there is no shame in selling down to your "sleeping point." Many investors' risk tolerance evolved in recent years as their financial situation or objectives changed, or as they learned more about their emotional reaction to market volatility. There are various ways to sell to a sleeping point, but selling everything to cash is typically not the healthiest option for long-term portfolios, especially when the market is arguably cheap and oversold. Ratcheting down exposure gradually tends to be a better approach.

These are just some of the actions investors can take right now. Given the recent market volatility and emotion, now may be a good time to communicate with your account managers and see what action you might be able to take.

Living with Volatility

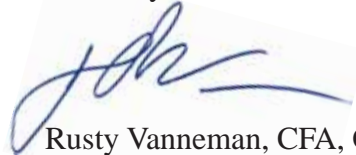
A few years ago, we were all spoiled to some extent with the several years of below average economic and market volatility. It now appears, however, that the near future will remain quite volatile. Regretfully, volatility is destabilizing. Volatility, however, also means opportunity. And now, given that the market is well off its all-time highs and at its cheapest levels in decades, the key is to stay involved, at least to the extent you are comfortable. Managing and monitoring volatility through a

balanced, diversified portfolio remains the best option for many investors.

To close this month's commentary, let's hear some words from Benjamin Graham, who remains arguably the most influential investor of the past century, and who wrote his classic text "Security Analysis" during the depths of the Great Depression:

"The investor who permits himself to be stampeded or unduly worried by the unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal." Benjamin Graham

Sincerely,



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