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## LETTER FROM THE PORTFOLIO MANAGERS

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May 2007

### ***Holding Tight — and Here's Why***



Eric M. Kobren

The stock market's performance in April was impressive. The S&P 500 and Dow Jones Industrials were up 4.5% and 5.9% respectively, posting their best months since December 2003. And, the consistency of the market has been exceptional as well. Over the last 18 months, the S&P 500 has finished higher a remarkable 16 times or roughly 90% of the time! To help understand just how exceptional that is, we examined the last 20 years of monthly returns. During this period – a time when the stock market posted some strong total returns - the S&P 500 posted positive monthly returns less than two-thirds of the time.



Rusty Vanneman

Despite this strong market action, we are holding tight with our current equity allocations in client portfolios. To explain why, we will address three factors: liquidity, earnings, and sentiment. Each of these factors had a hand in why prices moved higher in April, but each factor also provides reasons to not raise equity exposure now.

Before we get to those factors though, and while the topic of last month's returns is still fresh, we would like to briefly comment on some interesting market behavior last month. While the predominantly large cap Dow Jones and S&P posted strong returns, the Russell 2000, a benchmark for smaller companies, was up "only" 1.8% (still a nice return).

This relative underperformance by smaller companies was a bit of a surprise given that small cap securities tend to be more leveraged to the market (i.e., have higher betas) than larger companies. Again, examining the last 20 years of returns, when the S&P 500 was higher for the month, the Russell 2000 was on average even higher. And, when the S&P 500 was lower, the Russell 2000 was even lower. There are exceptions, of course. One notable exception was March 2000. That month, the S&P 500 was up 10% while the Russell 2000 was down 7%!

### **Liquidity**

So, why was April so strong for the markets? It isn't the economy (more on that later). Instead, one driving factor is the easy access to cheap money available to private investment funds that's allowing them to buy publicly traded companies and take them private. This is creating near-term demand for stocks and reducing the supply available for purchase. As a result, this drives up share prices.

Lombard Street Research reports that net retirement of stock in non-financial US companies reached over 5% of GDP in the last quarter of 2006. Approximately 85% of that was financed by debt of some kind, either through buy-backs, takeovers, or private equity. As reported by *The Wall Street Journal*, the current level of buyout activity is now larger than the buyout period in the 1980s. Thanks to this leveraged buyout (LBO) activity, along with increased merger and acquisition (M&A) activity and corporate stock buy-

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backs, more stock has been withdrawn from the market than has been issued in each of the last three years. According to the Federal Reserve, in 2005, \$295 billion in U.S. corporate stock was taken off the market. Last year, that number skyrocketed to \$548 billion. With nearly \$1 trillion of stock disappearing from the U.S. market in just the last two years, it's no wonder stock prices have moved higher. It's just basic supply and demand.

The rub is that eventually, these LBO firms will want to sell their equity back to the public so they can reap their profits. In other words, all this current LBO activity and contraction in shares will likely provide the fuel for an initial public offering (IPO) boom where there will be plenty of opportunities to buy stock in debt-laden companies. Given that M&A activity started to really pick up a few years ago, it should not be a surprise to see a surge in new equity issuance coming back to the market in the near future. If this scenario was indeed to play out, the supply/demand backdrop for the market could turn from a positive into a negative for private equity, the stock market, and especially smaller companies.

### Corporate Earnings

In the last week of April, the initial estimate for growth in real (inflation-adjusted) Gross Domestic Product (GDP) for the first quarter of 2007 came in at a 1.3% annual rate. The consensus expectation was 1.8%. This represented the weakest growth rate since early 2003, and the fourth consecutive quarter of below-trend real GDP growth (the long-term average is 3.5%).

Nonetheless, the headlines on quarterly earnings coming out of the corporate America remain mostly positive. Another oft-cited reason for the strong stock market performance in April was "better-than-expected corporate earnings." As of April 30<sup>th</sup> (approximately half of the S&P 500 had reported as of this time), operating earnings per share for S&P 500 companies were running around 7% higher than the prior year. At the beginning of earnings season, earnings growth was expected to be closer to 3%. This was a pleasant surprise indeed as beating expectations is good for stock prices, at least in the short term.

However, as with most market factors, it's not only the level, but the trend of the data that is critical to future market prices. After posting an incredible 18 consecutive quarters of double-digit year-over-year operating earnings growth, S&P 500 companies "only" posted a 9% gain (the long-term average is 6%) in the fourth quarter of 2006. With the first quarter of 2007 now running at 7%, the trend is clear: earnings growth is decelerating. Moreover, that growth is expected to decelerate further dropping to less than 6% for the second quarter of 2007, then down to approximately 2% in the third quarter. Despite the lift in April, it appears that the trend in corporate earnings will not be the stock market's friend in the coming quarters.

### Sentiment

We often talk about investor sentiment in this commentary. The idea behind using sentiment is that when investors reach an emotional extreme, either overly positive or overly negative on a particular market area, that area often tends to move in the opposite direction in the near future.

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There are several explanations for why this is the case. One explanation is that people's attitudes toward the markets and their actions are linked. In other words, if people indicate they are very bullish, they have either already put their money to work in the market, or are about to, and will soon have little buying power left.

Another possible reason is that markets move not so much on expectations, but on *changes* in expectations. Therefore, if everybody expects the market to move higher, any change in expectations would be to the downside, causing investors to sell their securities.

At the end of March, investor sentiment surveys were overly bearish. One example is the The Ned Davis Research Crowd Sentiment Poll, which registered a bearish extreme about that time. Going back to the mid-1990s, bearish extreme readings on this particularly indicator have been fertile grounds for rallies, producing on average 21% gain/annum for the S&P 500. In other words, at the end of March, sentiment conditions were ripe for a rally. And in April the markets complied nicely.

Where is sentiment today? By the later part of April, this very same sentiment indicator moved sharply higher to a bullish extreme. Extreme bullish readings in this indicator have historically produced forward 12-month returns of -1.6% for the S&P 500.

### Hold Steady

In the current market environment, with low interest rates, strong liquidity, and positive price momentum, reducing equity exposure doesn't seem to make sense. However, for the reasons cited above, it is not likely that we will be adding to our equity allocations any time soon either.

Our assessment of the risk/reward tradeoff in the market, causes us to believe the better part of valor is definitely discretion at this time. We are staying with our current asset allocations while continuing to focus on our discipline of building diversified portfolios consisting of money managers who we think can add value (within the parts of the markets that they invest in) regardless of market conditions. While glory may go to the bold, too often their medals are awarded posthumously.

Sincerely,



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Portfolio Manager



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Co-Portfolio Manager