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## LETTER FROM THE PORTFOLIO MANAGERS

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### ***Earnings Look Great Now But...***



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As the month of October drew to a close, the third quarter corporate earnings season was in full swing with approximately two-thirds of the companies in the S&P 500 having reported. As of this writing, it has been another great quarter for corporate profitability with nearly 75% of the companies beating expectations. These positive “earnings surprises” often push the market higher over the short-term as the underlying assumption is that corporations that beat expectations are showing unexpected positive business momentum that will translate into higher earnings and higher stock prices in the months to come.



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However, when companies report current earnings, they also provide “earnings guidance” for the next quarter (or several quarters). And here there have been very few positive surprises with only eight percent of companies (as of this writing) “upgrading” their earnings forecast for the quarter(s) ahead. There is, of course, a natural bias for corporations to “soft pedal” such guidance to help them “beat expectations” in future quarters. But even factoring in this behavior, these readings suggest a slowdown in corporate earnings into 2007.

While the third Quarter earnings should be very strong with an estimated 18% increase, analysts are forecasting less than half that rate of growth going forward, with single-digit earnings growth expected in 2007. These are market expectations. We tend to be even a bit more negative.

We have noted the connection between current earnings growth and future stock market performance before, but it bears repeating. Going back to the 1920s when year-over-year earnings growth is 20% or greater, the average gain in the S&P over the next 12 months averages about 2.0%. When earnings growth is between 5-20%, the subsequent gain in the S&P is only 5.5%. The “sweet spot” for the stock market actually comes when earnings growth is between -20% and 5%, then the next 12 months see an average gain in the S&P 500 of 13.1%.

At first, this data sounds counterintuitive, until one remembers that the stock market is a discounting mechanism. In other words, the stock market is trying to value anticipated future profits, not reward today’s profits. Given that corporate profits are cyclical, when current profits are very high, the odds favor lower profits ahead, and conversely when current profits are very low, it is easier to register higher profits in the future.

### **Housing and the Economy**

The first estimate of third quarter real (inflation-adjusted) GDP (the total value of goods and services produced by a nation) revealed an annualized increase of 1.6%. This is down from a 2.6% increase in the second quarter and is the lowest rate of growth since 2002. The weak third quarter slowed GDP growth over the past year to 2.9%, well below the long-term average growth rate of around 3.5%.

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There was, however, enough in the GDP data for both economic bears and economic bulls to slice and dice to fortify their arguments. Economy bears argued that if you stripped out a strong automobile production number, which, given the sales woes of Ford and GM, is unlikely to continue, GDP would have been a lot worse.

Economy bulls argued that the GDP figure was much better if you removed the plunging housing sector. Homebuilding, otherwise classified as “Residential Investment,” fell 17.4% in the third quarter - the largest decline since first quarter of 1991. And in the bulls favor, the action in home-builder stocks and some voices in the industry that we respect suggest that a lot of the bad news in that sector may be behind us.

We are not so sure, but in any case, stripping out housing seems to be a pretty big adjustment to us. If housing boosted the economy so much in recent years, why should it not be factored in now?

The housing sector has generated many sensational statistics and comments in recent weeks, including:

- The median price of a new home fell by nearly 10% — the biggest one-year drop since 1970.
- Single-family existing homes had price declines of 2.5%, the biggest drop on record according to Ned Davis Research.
- The supply of condos and co-ops available for sale is at an all-time record high.
- Fed Chairman Ben Bernanke predicted softening housing would probably subtract 1% from economic expansion in the second half of 2006, and possibly 2007.
- Ed Leamer, director of the UCLA Anderson Forecast. “We’ve had eleven sharp declines in the housing market since World War II, including this one. Eight of the last ten were followed by a recession.”

A slowdown in home building, home sales, and house prices will impact consumer spending in multiple ways. In addition, the impact of adjustable-rate-mortgage resets won’t help and the increase in defaults and foreclosures throughout the country will add even more stress. Not only may this impact upcoming holiday spending, but it could spill over into a reduction of economic growth and corporate profitability in the following year(s).

### **Performance Chasing And Volatility**

We have long argued that the largest impediment to individual investor success is “chasing performance.” Investors of all stripes love to buy funds that are doing well. It feels good and it’s easy to do.

We have also long argued the value of a well-diversified, risk-managed portfolio in helping investors avoid performance chasing behavior through lower portfolio volatility.

Now, thanks to a statistic calculated by fund-rating firm, Morningstar called “Investor Return,” we have some new empirical support for both of those arguments.

Investor return attempts to capture the returns actually earned by investors in a fund by weighting the fund’s performance according to the amount of assets in the fund. Mutual funds typically report total

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returns in a time-weighted fashion, where each time period has an equal weight in the over-all total return, even though the actual amount of investor assets in the fund are not equal over each time period, but tend to fluctuate. And they generally fluctuate in a predictable fashion; investors jump into hot funds after they have been hot for a while, and they sell funds after they have gone cold for a while. In other words, the difference between a fund's stated total return and what investors in that fund actually earn is a measure of performance chasing – the more investor performance lags, behind fund performance, the greater the amount of performance chasing that is going on.

One of our analysts here at Kobren Insight, Ben King, crunched both the conventional total return and the new investor return for the 68 Morningstar mutual fund categories. In 60 of the 68 categories (88%), the amount earned by investors was lower than the fund's total return over the last year. Over the last three years, 65 categories had lower investor returns (96%). Over the last five and 10 years the number improves a bit, but still 56 (82%) and 55 (81%) respectively, had lower investor returns. And this has been in an environment where momentum strategies (chasing performance) have tended to work better than usual!

To cite one example, the average technology sector fund posted an average annualized total return of 6.81% over the last 10 years. Yet, the average investor lost 1.63% per year!  
In sum, investors consistently chase performance, to the detriment of their long-term investment success.

Morningstar also examined the effect of volatility on the difference between a fund's total return and the investors' return. They looked at the most-volatile 25% and the least-volatile 25% of funds in every stock- and bond-fund category. In the low volatility funds, they found almost no difference in the 10-year total return and the 10-year investor return, with each around 8.9% a year. For the high volatility funds, however, while the total return was only a bit lower at 8.1% a year, investors' returns were much lower, averaging only 5.3%.

If investors do better by not chasing performance, and if lower volatility reduces performance chasing, then the concept of portfolios diversified by asset class and diversified by money managers — remains as powerful now as it ever has. Rarely does there seem to be the time to be 100% equities or 100% cash. Even now as we acknowledge the strong performance of the stock market in October, and the historically strong seasonal pattern of the fourth quarter and the presidential cycle for 2007, there are enough factors to warrant caution. Therefore, we continue to resist “chasing performance” by dramatically increasing our equity allocations.

Sincerely,



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