
LETTER FROM THE PORTFOLIO MANAGERS

November 2008

A Crisis of Confidence



Eric M. Kobren

The markets and economy were in crisis mode in October. Some say it was primarily a financial crisis; some say an economic crisis. Yet others say more specifically it was a credit, liquidity or collateral crisis. While there is truth to each of these statements, what connects them is a loss of confidence. This loss of confidence is more than just concern about future economic prospects; it also reflects how investors and consumers feel about their present situation. Additionally, it is a lack of trust in the financial markets. As a result of this lack of confidence, activity and prices in the financial markets have fallen and economic activity has contracted.



Rusty Vanneman

One notable and recent example of plummeting confidence was the statistical survey of Consumer Confidence (by the global non-profit organization Conference Board) for the month of October. In short, US consumer confidence tumbled to its lowest level on record (the data series was established over forty years ago) as Americans became much more pessimistic about their current situation and prospects.

Among the myriad of factors that impact consumer sentiment, the financial sector has been a driving force, including concerns about the liquidity, valuation, and security of financial assets either personally owned or owned by others. Weaker stock prices, for instance, negatively impact consumer balance sheets and moods. Thus, it probably doesn't surprise many that sentiment dropped so drastically given that the stock market just experienced its largest monthly drop since October 1987. People also tend to "pay attention" when the President, Federal Reserve Chairman, and Treasury Secretary all publicly discuss the possibility of a potential financial catastrophe! Lastly, it could be argued that the political season has also had a negative impact on the country's mood.

Weaker stock prices of late may explain a part of why consumer sentiment is so low now, but is there a relationship between extreme levels of consumer sentiment and future stock market returns? Yes, there is – but it might be surprising. Research has shown that stock market returns have tended to be well above average in the periods following lows in consumer sentiment.

What makes this really interesting is that consumer sentiment is also considered a leading indicator of a weaker economy. The thought goes that if consumers are pessimistic about their situation, they will tend to purchase fewer goods and services. This makes sense.

So, how does one reconcile the notion that low consumer sentiment is a leading predictor of economic weakness but also of stock market strength? Understanding this is a key part of appreciating how the market works and discerning how to incorporate economic data into the investment decision-making process.

As the saying goes, the stock market is a discounting mechanism. This means that the investment process should be forward-looking. Money should be invested in those areas that should be the most likely to

Continued ...

generate an attractive rate of return moving forward, not in those areas that generated the best returns in the recent past.

This forward-looking nature is a major reason why the stock market typically leads the economy. The standard rule of thumb is that the stock market tends to bottom four-to-six months before the economy does. This also means, of course, that the stock market has usually already found its footing and has started to move higher, in the face of current economic data that is still generally quite negative.

So, while plummeting confidence is a key reason the markets have fallen so much this year, and may mean that the economy will continue to be weak in the months and quarters ahead, it is not necessarily a reason investors should sell stocks now. If anything, low levels of consumer or investor confidence are typically very good market entry points for the long-term investor.

Government vs. Free Markets

With the massive government intervention of late, much of it led by individuals who are generally considered to be pro-market policy-makers, many investors seem to be quite concerned that this has been a radical new shift in economic thinking – abandoning free markets. Not so.

Back in the early 1970s, President Nixon made the comment that “We are all Keynesians now.” He meant that policy-makers of all political persuasions subscribed to the economic theories of John Maynard Keynes who believed in the power of the federal government to influence and shape the national economy, and impact the business cycle through monetary and fiscal policy. But in fact, Keynes’ impact on policy-makers goes back all the way to the Great Depression.

In short, Keynes’ key idea was that when there was less than full employment, the government could increase employment either by reducing taxation or increasing public spending, which would increase “aggregate demand” in the economy. This policy could be particularly effective when private demand was considered insufficient to maintain economic stability, particularly during periods of economic and financial stress – such as we have today.

Indeed, even economists who believe in limited government recognize the important countercyclical role that the government can play during periods of economic and financial stress as either (or both) the “lender of last resort” and the “spender of last resort.”

Animal Spirits

Another notable Keynesian observation was how “animal spirits” move the markets:

“Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action

rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”

These animal spirits (or lack thereof) form the basis of much investor behavior, especially over short time periods. In the current environment, despite the increased likelihood of better long-term returns, the urge to get out of the market, where it feels safer, has dominated price action ... animal spirits are in full retreat.

Indeed, many of the fundamental and technical templates and relationships that have provided a framework for effective investment decision making have not worked in recent months. While it could be argued that market and economic activity through the end of September were still within the templates of recent decades, the volatility and market behavior in October was clearly “outside the box.”

Nonetheless, both the extent of the losses and the extent of the pessimism have created an interesting attitude among many fundamentally-based money managers. In short, they are excited. Some are the most bullish they have ever been in their careers. Also, as recently observed by an “old salt” in the industry, with many years of money management experience, when everybody seems to be saying that “nothing works” for making investment decisions, that is usually a sign of the market trying to bottom.

How Long Before I Get My Money Back?

Though Keynes’s views on investing evolved, he once stated that a rational investment policy would be ineffective because of the irrationality of the markets. While we agree that emotions dominate the market in shorter time periods, we disagree with the notion that a rational investment plan for long-term investment is ineffective.

“Long-term” is a phrase many investors now greet with the concern that they may never recover all of their recent losses (as measured from their all-time investment portfolio value peaks). The answer, however, is probably along the lines of “not as long as you might think,” though the best answer depending on the individual situation is that “it depends.” The investor’s time horizon and financial markets make a difference, but the answer also depends upon whether or not the investor abandoned (albeit temporarily) the stock market until there was “more clarity.” Selling investments after losses not only converts temporary losses into permanent losses, but it foregoes the opportunity to participate in the eventual recovery.

12 Months Ended	Trailing 12-Mo. Return	Next 1-Yr. Return	Total 2-Yr. Return
Sep-74	-38.9%	38.1%	-15.6%
Sep-01	-26.6	-20.5	-41.6
Mar-03	-24.8	35.1	1.6
May-70	-23.3	34.7	3.3
Aug-88	-17.8	39.0	14.3
Oct-62	-14.9	35.3	15.1
Jul-82	-13.4	59.4	38.0
Sep-66	-12.0	30.6	14.9
Dec-57	-10.8	43.4	27.9
Sep-90	-9.3	31.3	19.1
Average	-19.2%	32.6%	7.7%
Median	-16.4%	35.2%	14.6%
# Positive	0.0%	90.0%	80.0%

Source: Ibbotson Associates.

Assuming an investor stayed the course during past bear markets, how long did it take to recover losses? Looking at the worst 12-month returns since 1957 (excluding the current bear market), the stock market was actually able to recover all of its losses over the next 12 months eight times! While that is not necessarily our expectation, history suggests that it is possible.

What Can We Expect For a Long Term Return?

Now, let's look at the situation in a different light. This time we will take a glimpse at what the long-term return for the stock market might be if we assumed simply an average earnings growth rate and an average price/earnings ratio over the next dozen years.

Currently, 2009 earnings forecasts for the S&P 500 are widely divergent. On an operating basis (which excludes one-time, non-recurring items) the forecast is \$94/share. But reported earnings which don't exclude those items are expected to come in at \$48/share. Such a wide divergence (reported earnings only 50% of operating earnings) is highly unusual. Over the last 20 years the relationship has been closer to about 90%. In the past when there has been a difference that big, explosive growth in reported earnings generally reconciled this historical relationship.

However, we also believe that operating earnings expectations for 2009 have likely not been reduced enough. So, for the sake of illustration, if we think that \$94 is too high and \$48 is too low, let's just split the difference and say that earnings for 2009 are more along the lines of \$71.

In terms of earnings growth, over the long run earnings basically grow at about the same rate as nominal GDP or about 6% a year. At that growth rate, earnings will double in 12 years. That takes earnings to \$142/share for the S&P over that time frame.

The average P/E for the past 50 years is 17.7 times earnings. Applying that to our \$142 in earnings gives us a value for the S&P 500 12 years from now of over 2500 (or more than 2.5 times its current level). That works out to a price appreciation of over 8% a year, excluding dividends which are currently over 3% a year. Add in dividends and it would seem reasonable to expect the market to return nearly 12% per year over the next dozen years.

With a 12% annual return, an all-equity S&P portfolio would double in approximately six years. Of course, the markets are human and much messier than that, generating big gains in some years and losses in others, but over time returns are indeed determined by the long-term fundamentals of earnings growth, valuations, and dividends.

12 Months Ended	Trailing 12-Mo. Return	Next 1-Yr. Return	Total 2-Yr. Return
Sep-74	-38.9%	38.1%	-15.6%
Sep-01	-26.6	-20.5	-41.6
Mar-03	-24.8	35.1	1.6
May-70	-23.3	34.7	3.3
Aug-88	-17.8	39.0	14.3
Oct-62	-14.9	35.3	15.1
Jul-82	-13.4	59.4	38.0
Sep-66	-12.0	30.6	14.9
Dec-57	-10.8	43.4	27.9
Sep-90	-9.3	31.3	19.1
Average	-19.2%	32.6%	7.7%
Median	-16.4%	35.2%	14.6%
# Positive	0.0%	90.0%	80.0%

Source: Ibbotson Associates.

Where to Invest Now?

In the equity market, large-cap stocks appear particularly attractive right now. This may seem counterintuitive since large caps generally tend to lag in stock market rallies, but what makes this environment different is that large caps are trading at extremely cheap levels compared to small caps. This is especially so for higher quality large-cap names. This valuation gap has been building for several years, but has been exacerbated recently by institutional investors reacting to the sharp market declines by selling their most liquid names (typically large-cap stocks), as they are typically easier to sell. Once the market stabilizes, large caps should recover some of that lost performance. In addition, large caps tend to benefit more than small caps during periods when the government is injecting massive amounts of liquidity into the economy such as we are seeing today. Given all that, plus the fact that domestic large cap stocks have been the worst performing part of the stock market over the last decade, we think it's their time to shine.

For all the dislocation in the equity markets of late, the fixed-income markets have seen even more. While conventional Treasury bonds have held their own in recent months, other sectors in the fixed-income markets have not fared well. As a result, some incredible values have appeared for the long-term investor. Corporate bonds, investment-grade and high-yield, are trading at extremely attractive yields compared to conventional Treasuries. Mortgage-backed and municipal bonds are also relatively cheap. Treasury Inflation Protected Securities (TIPS) have been hurt in recent weeks due to their relatively illiquid nature (and waning inflation fears). As a result, 10-year TIPS are now selling at a breakeven inflation rate of just 0.91%! At those rates, TIPS offer incredible value relative to nominal Treasuries for investors who want a Treasury-only portfolio. In fact, about the only areas in the fixed-income markets that look expensive are conventional Treasuries and cash.


Fear and Attractive Valuations Equals Opportunity

The extreme crisis in confidence we are going through has punished both the markets and economy, and we must acknowledge that all the damage may not be done. But the flip side of the coin is that the critical preconditions required for a fresh bull market – good valuations and extreme fear – are now in place. While short-term movements in the markets are primarily a function of volatile investor confidence and “animal spirits,” we believe that eventually the long-term fundamentals of earnings growth and low valuations will provide patient investors attractive returns going forward.

Sincerely,



Eric M. Kobren
President
Portfolio Manager



Rusty Vanneman, CFA
Director of Research
Co-Portfolio Manager