
Letter From The Portfolio Manager

November 2009

Quality is the Key



Rusty
Vanneman
CFA, CMT

Key Points

- The furious market rally since March has been led by lower quality companies.
- Higher quality companies now appear to be the most attractive they have been in decades.
- How should you use market outlooks? It depends.

Despite an extremely volatile closing week to the month, the markets survived October. The Dow Jones Industrial Average even finished the month with a gain.

This occurred despite a steady drumbeat intoning that the markets and economy simply couldn't continue to prosper. Even though earnings and economic data generally surprised to the upside last month, many investors and consumers remained deeply skeptical. One remarkable statistic capturing this negativity from late last month was how consumers assess the "present situation." In short, it dropped to its most pessimistic levels since 1983.

While this angst is real – many people's financial situations are indeed tenuous without the apparent near-term prospect of improvement – the stock market isn't trying to empathize with anybody. If anything, the markets, due to continuous adaptation to evolving expectations, are usually moving in directions that seem to frustrate the conventional views and emotions of most investors.

The conventional view in recent months is that the stock market is in need of a deep breath. That seems plausible given that the global stock markets have covered a lot of ground fairly quickly. Some even remark that the gains are nonsensical – and indeed this may often seem the case given the framing provided. A counterpoint, however, is that the severity of the preceding panic sell-off set the stage for a massive relief rally. This probable rally, coupled with the government's tidal wave of liquidity coming from its fiscal/monetary stimulus – a whopping seven times larger (!) than its typical response to recessions – should perhaps instead beg the question "Why is the S&P 500 only up 17% this year?"

So...can the gains continue? In this month's report, we'll review our outlook. In addition, given the strong rally this year off the March lows, we believe that some interesting investment opportunities have developed.

Market Outlook – It Depends

I'll admit it, as an investment manager of balanced portfolios, I have a problem with the heavy demand for stock market predictions. While market outlooks are what many investors think they

want the most, it really just puts emphasis on the wrong things when it comes to successful investing. Investing is not like a game of Texas Hold 'Em. Decisions don't have to be all or nothing.

The biggest problem with forecasts, of course, is that nobody knows the future. The best an investment manager can do is to build a portfolio with a perceived favorable probability that it will succeed over time. Long-term investment success is about principles, not predictions. Was the investment process disciplined? Were investments bought at favorable valuations? Were transactions costs reasonable? Was adequate due diligence conducted? None of this guarantees certainty, of course, but it should enhance the possibility of success over time.

There are other issues with outlooks. For one thing, it's really only part of the job for most investment managers (for some, it has no part), who also serve many other important investment management functions. In addition, forecasts are subject to change. An outlook from a prior period should change if the facts change. This is more difficult than it sounds for numerous money managers.

Another problem with outlooks is how they may be utilized. How an outlook should be applied to a particular situation should depend on that particular investor's personal circumstances and what they already own. For instance, if an investor has an equity heavy portfolio, but this portfolio should be more conservative given the investor's specific objectives and time horizon, there is no reason to delay reducing stock market exposure simply because they heard or read an outlook which stated the stock market could go higher in the short term.

This lesson was revealed to me many years ago, though I didn't fully comprehend until several years later. Decades ago, at an unofficial student-parent social event at a Cambridge, Massachusetts watering hole, I recall some of my friends' parents continuing to press another parent, who happened to be a successful investment professional. They wanted to know what he thought of the market and where they should be investing. While he handled the situation with complete social grace and ease, his basic response was "it depends." At the time, I thought that was a bogus response. He should say! Did he not have an opinion? Was he just trying to get people to call him at the office and sign up to be a client? Being a skeptical college student (heck, I'm still skeptical), my thoughts at the time leaned that way, but upon further reflection the answer was simply in what he said at the time – it depends. It depends on each client's personal situation.

Okay, disclaimers aside, let's now review what we currently think are some segments of the stock market that we believe have the odds in their favor and could outperform in the year(s) ahead.

Market Outlook – High Quality

One distinctive characteristic of the rally since March is that lower quality securities have significantly outperformed higher quality securities. This sort of price action is typical of market and economic recoveries as lower quality securities are typically hit the hardest during the preceding market correction. Lower quality securities also tend to be the most leveraged to the economy. In other words, they tend to have the biggest improvement in company fundamentals when the economy improves and the most deterioration when the economy falters.

According to Morgan Stanley, the lowest quality companies outperformed the highest quality by approximately 40% year to date through the end of September. The performance differentials are approximately 100% since the end of February! The result of this price action is that the relative valuations between high quality stocks and low quality stocks, or even just against the broad market, now strongly favor higher quality companies. One leading and well-known money manager, Jeremy Grantham, even estimates that high quality stocks will now outperform the broad market by nearly 7% a year for the next seven years. If it comes to pass, that's a lot of outperformance. To put this potential relative performance into context, if high quality stocks surpass the market by 7% a year for the next ten years, that means they could double the market's performance. Not bad given that high quality stocks tend to be the "boring" safe stocks.

What do we mean by quality? There are a few firms that have their own methodology for determining what "quality" means for an individual company stock and we're part of that list. Basically, when we think of quality we are thinking of companies that first and foremost tend to have higher and more consistent levels of profitability, while secondary factors include debt levels (lower is better), market capitalization (high is better), and dividend yield (higher is better).

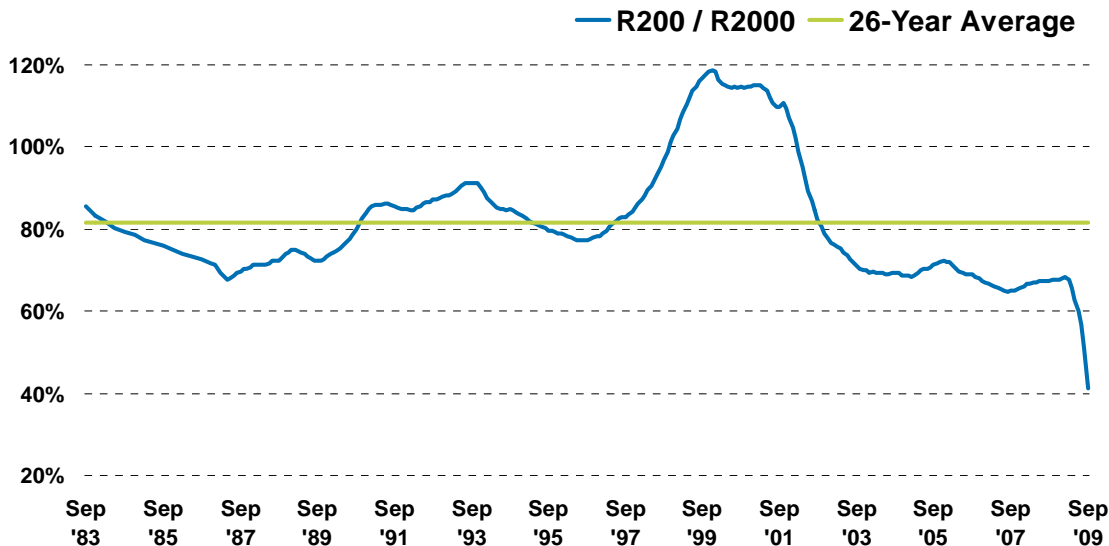
Given this criteria, the market segments that tend to screen well for higher quality should seem fairly obvious given the basic parameters. They include larger companies as well as growth companies. Economic sectors that tend to have higher quality scores include Software as well as more defensive sectors such as Health Care and Consumer Staples. Next, let's look in a little more depth at the larger and fast-growing parts of the market.

Market Outlook – Large Cap Stocks

Large cap stocks are arguably the cheapest they have been in decades.

Below is a chart of large cap stocks versus small cap stocks. We use data from Frank Russell, which has monthly data going back to 1978. The relative valuation measure that we use is a five year rolling average of the monthly relative valuation between the Russell 200 (large caps) and the Russell 2000 (small caps) using Russell's price/earning ratios. Typically, the Russell 200's price earning ratio is 80% of the Russell 2000's. Currently, it is at 40%. One way to reconcile the gap from the long-term relative valuation average is for large caps to double the relative performance of small caps.

It is important to remember that large cap stocks make up about 70% of the over-all stock market. Small cap companies meanwhile make up about 10% of the over-all market cap. Mid-sized capitalization stocks make up the difference.

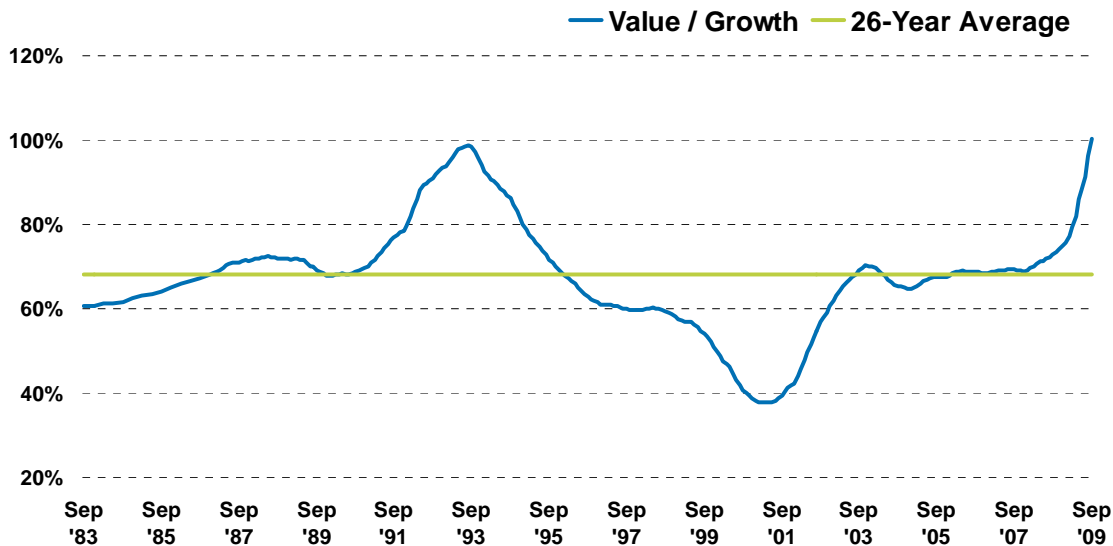


Relative valuations are our chief attraction to larger companies. There are other reasons we like large companies. They tend to be less volatile. They are inclined to have higher dividend yields. They also acquire a greater share of their revenues from overseas sources. They should be better equipped to handle additional government regulations. Given these factors, we believe that within client equity holdings, maintaining at least a market weight or more to larger companies (70%) and a market weight or less to smaller companies (10%) seems to make sense.

Market Outlook – Growth Stocks

The attraction for growth stocks is similar to that of large cap stocks.

Using the same methodology and data source as above, we have seen relative valuations between growth and value stocks like this before. Growth stocks were also relatively cheap back in the early '90s. And, it should be noted that by the end of the decade, growth stocks did indeed significantly outperform value stocks. By the end of 1999, for instance, growth stocks had outperformed value stocks by 9% a year over the prior five years.



What distinguishes a “growth” stock from a “value” stock? Firms have different classification methodologies, but the key generic differences are fairly obvious in that value stocks tend to have lower growth rates and lower valuation ratios while growth stocks tend to have higher growth rates and higher valuations.

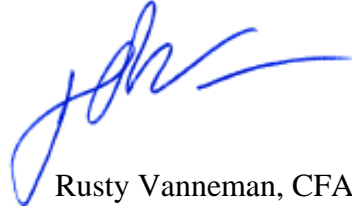
Summary

Given the current relative valuation backdrop, higher quality segments within the stock market appear to be the better place for the foreseeable future. This should appeal to both the more enterprising investor, who wants to actively seek higher relative returns, and the more defensive investor, who might want more stable, higher yielding fare in an absolute sense.

High quality is indeed our preference – at least for now. This won’t always be the case. While countless money managers have achieved great success by consistently favoring higher quality companies (Warren Buffett for example), we will shift our preference back toward lower quality securities when relative valuations, combined with other factors of course, suggest that we do so.

How long may that be? Typically, a shift in relative valuations of this sort may take years, but in the market environment of the last few years, these dramatic shifts are now often being compressed into a matter of months. As usual, the levels and trends in the relative attractiveness of various market segments will need to be carefully monitored. Keep your seatbelts on.

Sincerely,



Rusty Vanneman, CFA, CMT
Chief Investment Officer
Portfolio Manager

The investment ideas and expressions of opinion may contain certain forward looking statements and should not be viewed as recommendations, personal investment advice or considered an offer to buy or sell specific securities.

Kobren Insight Management's statements and opinions are subject to change without notice and should be considered only as part of a diversified portfolio. You may request a free copy of the firm's Form ADV Part II, which describes, among other things, affiliations, services offered and fees charged. Past performance is not an indication of future returns.

©2009 E*TRADE FINANCIAL Corp. All rights reserved.