
LETTER FROM THE PORTFOLIO MANAGERS

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When Others Are Fearful



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Recently, a long-term associate was talking about his morning routine when it came to getting his morning news. He gets up, turns on his computer in his study, goes down and gets his newspapers and a cup of coffee, then comes back to the computer. Once he logs onto his favorite internet news sites, he throws his newspaper away. “It’s already old news...I might as well be reading a paper from a few days ago.”



Rusty Vanneman

Major economic news has indeed been flowing that fast and furious in recent weeks. Larger than normal boldfaced headlines in major newspapers at 5 am already seem dated. This really isn’t a comment on old versus new media, but more a comment regarding the onslaught of news flow that has been unsettling and unpredictable.

Getting quality information quickly, ideally before others, has always been a key element of successful investing. Another way to attain an edge, however, is by conducting superior analysis of that information. This has been increasingly important as information has become more widely accessible to investors in recent years.

A third way to find an advantage, however, and often the most important, is behavioral. This is the ability to maintain discipline in various market environments, the ability to go against the crowd, and the ability to be patient.

What does all this have to do with the current environment, especially a real estate/credit/liquidity/confidence crisis that many have called the worst crises of their lives? First, we recommend that investors cut down on their information intake. In the current environment, where financial and emotional stress is high, and sensational opinion and conjecture are easy to find, sifting through the river of information to discern what is important and what is just “noise” can be difficult, especially when most of it is, in fact, just noise.

For those who are investing for longer-term goals, the key is to maintain discipline and patience. What is going on now is indeed serious and has been financially painful – for all of us. Nonetheless, the market has been through crises before. The markets will eventually stabilize. The markets will, at some point, resume their ascent. Perhaps the recovery starts this month. Perhaps it starts next year; perhaps even later. For the long-term investor though, there are indeed stronger reasons to buy now than to sell.

In this month’s commentary, we will talk about three things. First, we will provide our quick take on the government’s rescue plan. Second, we will talk about the incredible market volatility that we have seen, and why it actually suggests higher returns moving forward. Lastly, we will talk about the basic building blocks of long-term equity returns – and why expected returns for stocks look better now than they have in a long time.

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Rescue Package

The reason the economy is in this current mess really began with the real estate bubble. There were many contributing factors to the bubble, including low interest rates, government incentives, excessive debt, and good old human nature. Bubbles happen. Bubbles also burst.

As a result of the real estate bubble bursting a few years ago, prices have fallen, foreclosures have risen, and credit conditions have deteriorated. This in turn has resulted in reduced demand for mortgage-related securities. Lending standards then tightened, which translated into fewer mortgage loans written, which meant less demand for housing, pushing housing prices lower still, and the cycle has continued to repeat. We are still in that vicious cycle.

A key aspect of the current situation is the lack of liquidity. Market participants simply don't want to transact business right now. While on one hand deleveraging and cleaning up messy balance sheets is healthy economic behavior in a micro sense, on the other hand, with banks less willing (and less able) to lend, many organizations and individuals who need access to capital can't get it. This is negative for the economy.

This contraction in liquidity and its negative impact on the economic system became much more prominent in September. Many household names in the financial sector ran into trouble. Just to name a few; Lehman Brothers filed for bankruptcy, Merrill Lynch was bought out by Bank of America, and AIG was bailed out by the Federal Reserve. The stock and bond markets captured the angst in the markets, with sharp volatility and sharp price drops. Serious dislocation occurred in the fixed income markets, including U.S. Treasury bills plummeting to essentially zero yields. The lack of liquidity ripple effects started to turn into waves of fear and a loss of confidence in the system. The damage on Wall Street was starting to spill over onto Main Street.

This is where the federal government stepped in and became much more involved. While nobody thinks the rescue package passed by Congress is perfect, it stands a good chance of restoring some confidence and liquidity back to the markets. We believe that this is an important first step toward an eventual turnaround, even if a full economic recovery is still months or quarters away.

Regardless of one's political persuasion, it should be recognized that in an environment where industry and consumers are deleveraging, the U.S. government has the ability to leverage up and offset some of the economic contraction. While many think that Warren Buffett is the ultimate example of a patient, long-term investor (by the way, he is buying in this environment), the government has advantages that even Warren Buffett doesn't have. Who has a larger war chest? Who has a lower cost of funds? Who is going to be around a lot longer? The government, love it or hate it, is perhaps the only entity that has the ability to stabilize the situation.

An important reminder is that according to the International Monetary Fund, the past quarter century has seen at least 124 banking crises around the world. This also isn't the first time that the U.S. financial system has experienced a financial crisis, and it won't be the last. Nonetheless, the markets and economy have always recovered and moved onto new highs.

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Volatility

Market volatility has been nothing short of intense in recent weeks. Whether one looks at point moves or percentage point moves, the volatility has been dramatic and historic. When volatility gets extremely high, many investors simply abandon ship and move to what feels like safer ground. Abandoning an investment plan during times of high volatility is generally not healthy investor behavior.

One common way to measure volatility is the VIX or Volatility Index which reflects the market's expectation of what price volatility will be like over the next 30 days and is often considered a way to measure investor fear. A typical VIX level is below 20 (meaning an expectation that annualized volatility will be less than 20%). A level above 30 is a signal that investors are fearful. Levels above 40 typically suggest panic. *The VIX Index nearly hit 47 at the end of September.*

Studies have shown, however, that investors should “be greedy when others are fearful.” The table below shows the handful of times that the VIX spiked over 40 over the last ten years. For the most part, buying the market during periods of such extreme stress has produced positive returns moving forward.

	VIX	S&P 500 Total Return after			
	Level	1-Month	3-Month	12-Month	3-Year
8/31/1998	44.28	6.41	22.03	39.86	7.14
9/17/2001	41.76	3.80	9.58	-14.65	4.55
7/22/2002	41.87	17.62	9.06	22.74	16.64
9/19/2002	40.65	5.02	5.35	25.16	15.48
Average	—	8.21	11.51	18.28	10.95

High market volatility often pushes investors off course when it comes to their long-term investment portfolios. The irony is that those high volatility periods tend to be more closely associated with market bottoms, than market tops.

Long-Term Return Expectations

Warren Buffett, among others, is fond of saying that he is a lot more comfortable with his approximate return expectations over the next 5-10 years than his expectations for the next 5-10 months. The reason he can say this is that while fickle investor sentiment tends to dominate short-term market activity, valuations tend to determine long-term results.

Currently, the outlook for the stock market is the best it has been in quite some time. Let's review the basic building blocks of long-run equity returns:

1. Dividend yields
2. + earnings growth
3. + or - any change in valuations (P/Es)

First, let's look at dividend yields. Currently, the dividend yield on the S&P 500 is 2.6%. This favorably compares to the 25-year average of just under 2.5%. It is also the highest dividend yield since the mid-1990s. Investing in the S&P in the mid-90s would have generated an annualized return over the next ten years of approximately 10%. And compared to Treasury bills, stock yields are the most attractive they have been since the 1950s!

Second, what can we expect in terms of earnings growth? Going back to the 1920s, annual earnings growth has been about 6% per year. While this number obviously has significant short-term cyclical associated with it, the long-run trend of earnings growth has been very stable.

In recent years we had been in favor of reducing long-term return expectations due to above-average valuations, but we no longer maintain that view. While the current price/earnings ratio for the S&P 500 is 21 times the last twelve month reported earnings, about in line with its 25-year average, the P/E ratio using expected earnings over the next twelve months is 14 times. The typical price/earnings ratio when the economy troughs is about 19 times.

When interest rates and inflation expectations are low, as they are now, they are supportive of higher valuations on stocks. Valuations also tend to be higher when transaction costs and tax rates are low. This is also currently the case.

All in all, an argument can be made that stocks today are relatively cheap. At worst, they are fairly valued. To be fairly conservative, let's say that our expected ten year return for the stock market gets only a slight boost, say approximately +0.5% per year, from changes in valuations.

Putting the three components together; a yield of approximately 2.5%, a 6% earnings growth rate, and +0.5% increase in valuations (P/Es), we come up with an expected return of 9% in the coming years. While this isn't the 10%+ that many investors have come to expect from the stock market, it is better than the 3% annualized return that we actually saw from the S&P 500 over the last ten years that ended on September 30th.

That compares to ten-year Treasury bonds yielding less than 4% and cash closer to 2%. **Bottom line, this is the best that expected returns for stocks have looked in absolute and relative terms in a long time.**

Don't Wait for the Wind and the Weather to Be Right

Periods of high volatility, just like periods of low investor confidence, thankfully tend to be fairly short in the grand scheme of things. Even though the information flow is heavy and emotions are running high, long term investors should continue to make investment decisions primarily due to long-term factors such as valuations. Starting valuations drive long-term returns.

Besides, there is a saying that if you wait for the wind and weather to be just right, you will never plant anything or harvest anything. Many investors now are waiting for the market to stabilize or

some other sign that the wind has stopped blowing. However, numerous studies have shown that waiting until after the market begins to recover means that you will miss much of the market's long-term returns. You have to be in the market to earn its return.

Sincerely,



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