

Investment Commentary
December 2008

You Decide

"Surviving has to be done by the use of intelligence, not through expecting miracles."

—Gerald M. Loeb, *The Battle for Investment Survival*

- The hardest task of investment decision-making is balancing all sides in the midst of a brutal bear market. However, good investment decision-making requires that we do so and we offer 10 reasons to balance the preponderance of negative news.
- The positive case for stocks has to rest on criteria that demonstrates value and opportunity.
- These are unprecedented times and uncertainty is high. Ultimately, investors have to weigh the risk and reward of stocks against their own self interest.

The case for investors to avoid stocks is easier to make. The three-headed monster of deleveraging, economic deterioration, and fear has decimated equity wealth in the last 14 months. Credit markets remain stressed, corporate earnings are declining, and volatility is incredible. The prudent course appears obvious—to stay defensive until some of the considerable economic pressures become less uncertain. But against this backdrop are the reasons to invest. The easier course in investing, as it is in most things in life, is to minimize the dissonance that comes from balancing all sides. In a bear market, this becomes more difficult as time horizons shorten and the risk of investing is accentuated rather than its rewards.

We have experienced a major bear market that by magnitude and length is among the worst in the last 100 years. Investors are disappointed, demoralized, and fearful. However, if the past tells us anything it is that periods of great pessimism are the conditions that create better future returns. Major bear markets have been followed by major recoveries because stocks offered good value and opportunity to grow wealth versus alternative investments. This is the threshold question that investors need to ascertain. Given the preponderance of negative news, we wanted to balance perspectives with 10 reasons why an investor, with a reasonable time horizon, should look at the stock market opportunistically. Whether these reasons are enough to counter the present uncertainty is something that every investor, with their unique circumstances, has to answer for themselves.

1) Massive Fiscal and Monetary Stimulus

Between the Treasury use of TARP funds and a \$500 billion package expected with the new administration, fiscal stimulus measures are expected well over \$1.2 trillion or close to 10% of GDP. The Federal Reserve is now fully engaged in "quantitative easing" or steps that will reduce interest rates on longer-maturity securities. The first beneficiary of these actions is likely to be mortgage-related GSE securities that will spark a significant wave of refinancing activity. All of these measures should help stimulate economic growth in 2009.

2) Valuation

Using forward 12-month consensus estimates of operating earnings, the P/E ratios for most of the broad stock market indices are around 11.0x. The average inflation-adjusted P/E ratio with CPI at 2.0% is 19.6x for the S&P 500 and the long-term average P/E ratio is 16.0x. Price to cash flow (P/CF), price to sales (P/S), price to book value (P/BV), enterprise value to EBITDA, and P/E to long-term estimated EPS growth (PEG) all paint a picture of depressed valuation. In bear markets, investors become fixated on near-term earnings and ignore the basis of intrinsic value for stocks. Intrinsic value places a greater emphasis on longer-term cash flows in determining investment value. Given the current high level of risk aversion, the future values of stocks are being significantly discounted.

3) Dividend Yield

The dividend yield on the DJIA is 3.7%, which is 100 basis points above the yield on 10-year Treasury bonds (2.7%). The last time the DJIA dividend yield exceeded 10-year Treasuries was in 1962 and was followed by a robust market rally.

All relevant disclosures appear on page 3 of this report.

While certain DJIA constituents will likely reduce dividends (Citigroup, Bank of America, etc.) others will likely increase their payouts (Wal-Mart, McDonalds, Procter & Gamble, etc.). Assuming earnings and dividends grow at 5% per annum for the next 10 years (below the long-term average of 6%), and the DJIA sells at the same P/E as today (11.0x), the total return for the DJIA is 75% higher than current 10-year Treasury bonds.

4) Trailing Performances

The trailing 10-year performance of the DJIA is negative, which last happened in 1982 and 1974. Both periods were followed by major, multi-year bull markets. From a S&P 500 standpoint, trailing 10-year performances are into a second standard deviation below their historical mean.

5) Already Experienced a Major Bear Market

As measured by the DJIA, the stock market has experienced a bear market that is as deep as all except in the early 1930s. In each of the eight largest declining periods (DJIA down 47% or more), recoveries were a "V" shape, or a sharp rise, in percentage terms.

6) Negative Sentiment

The Ned Davis Crowd Sentiment survey is a compilation of short- and long-term sentiment readings from a range of investors. The current reading is lower than the three previous bear markets. At extremes, sentiment has been a reliable contrarian indicator. According to the latest equity mutual fund flow data, net redemptions have far surpassed the previous peak at the bottom of the 2002 bear market. Like sentiment, record net inflows and outflows are telltale signs of market tops and bottoms.

7) Cash on the Sidelines

Cash in money market funds are almost half the value of the S&P 500 and are higher than in 1982, which was the beginning of a secular bull market. Free credit balances at NASD firms are also at an all-time high.

8) Investment Alternatives

The current investment environment is shunning almost all risk assets from stocks, to corporate debt, to real estate. While risk-less assets offer protection of principal, they offer little in the way of growing wealth to meet financial objectives. The stock/bond ratio measured with government bond yields is wildly positive for investors although corporate debt is a different matter.

9) Economic Data is Often Lagging

Stocks are mostly a leading indicator for the economy. Stocks in October 2007 peaked before the "official" recession began in December 2007, in advance of most investors' expectations that such conditions had occurred. Historically, the stock market bottoms before GDP turns higher, unemployment peaks, and consumer sentiment improves.

10) Warren Buffett

Warren Buffett is not someone who often offers market opinions. In 1974, when stocks were experiencing their worst bear market since the 1930s, Buffett described himself as a, "sex-starved sailor in a harem" in perusing the opportunities. In 1999, when the tech-inspired bullishness reached incredible heights, he warned that future returns would be far lower. In October 2008, Buffett said "Buy" knowing full well that near-term economic news would be lousy but "if you wait for the robins, spring will be over."

Richard E. Cripps, CFA
Chief Investment Officer



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