Second Quarter 2009 Review & Commentary

Overview

What a difference six months makes. As we mark that period from lows of early March, it seems like years ago. Perhaps that's because it has been a few years of average performance since then. To illustrate this, and as a departure from the normal format, year-to-date returns through August 31 are shown below. Returns from the March lows will be discussed in the commentary section.

Equities (Stocks)

Domestically, Large Cap US stock funds gained 16.5% so far this year through August 31. Riskier equity asset classes had even more dramatic recoveries with the average Mid Cap fund gaining 23% and the average Small Cap fund gaining 19.3% through August 31.

The same rebounding theme continued overseas as well. International funds had an average gain of 23% through August 31. Emerging Markets continued to exhibit extraordinary volatility, albeit in a positive way, with a return of 49% year-to-date.

Gold Oriented funds were one of the very few losers having given up 6.3% since the beginning of the year. Real Estate funds continued their impressive rebound with a 12.4% year-to-date return, which was helped by a return of over 13% in August alone.

Fixed Income (Bonds)

Bonds also participated in the excitement, although to a lesser extent. Long–Term Bond funds averaged 13.5% for the period. Riskier High Yield funds pulled ahead with an average return of 32% for the period.

Second Quarter 2009 Commentary

"History is but a lantern over the stern"
Samuel Taylor Coleridge

While these numbers may sound pretty good (and they certainly are), consider for a moment from whence we came. From lows reached in March, the S&P 500 has gained 53% through the end of August. The Russell 2000 Index, which measures stocks of smaller companies, has gained 67% since its intraday low reached on March 9. Perhaps most telling is the performance of my favorite domestic equity index, the Value Line Composite. This index doesn't get much press, but I consider it to be the best representation of how the average stock, and thus the average investor, actually does in the real world.[1] The Value Line has gained 86% since March. Before you start lamenting that your portfolio hasn't had an 86% return in the last six months, you should know that the index had lost 70% since July of 2007 and was lower than when data became widely available in 1985.

In my fourth quarter 2008 commentary (distributed in February, the near depth of the misery), I included the following:

> *I've made a little game over the years of making the most improbable sounding predictions in conversations and when I get the look that implies I must be insane, I know I'm on the right track. It happened in 1999 when saying the dot-coms would implode and again last year when I said the price of oil would crash. It happens most recently when I say that in the next year or two we'll see a 12 month period with a 50% rise in the major stocks average.*

I quite strongly believe the average investor would read the above two paragraphs and conclude (wrongly) that everything is fine and now is a great time to invest in risk assets. They might also conclude (very, very wrongly) that I am prescient and have a crystal ball that actually works.

Let's examine at length the first conclusion and then give the second conclusion all of the respect it deserves, that is to say virtually none. In the depths of the last decline people would say something to the effect "why not just go to cash and then get back in when things are better?" The problem comes in defining "better." Intellectually it is easy to understand the concept of wanting to buy things that *are going to go up* rather than things that *have gone up*, but most people are simply unable to pull it off emotionally. Said another way, it's difficult as an investor to be simultaneously comfortable and successful.

The reality is that most people believed March 9th was a terrible day to invest and that August 30th was a much better day to invest. Let's look at the data and see why the emotional doesn't reconcile with the rational.

Over the last 20 years through the end of 2007, which avoids most of the recent unpleasantness, the average annual return for the Value Line is around 5% (yes, it seems low, but I would encourage you to follow the link in the footnotes below and look for yourself) and about 9% for the S&P 500. Taking compounding into effect, the returns for the last six months for the Value Line represent about 13 years of average returns and the returns over the same period for the S&P 500 represent about 5 years of returns. Looked at another way, the lows reached by the S&P 500 in March were last seen in 1996, so in a sense the returns of the last six months represent 13 years of returns for the S&P 500 as well. No matter how you look at the returns of the last six months, it's an awful lot, awful quickly. It is simply mathematically impossible for returns to continue much longer at this pace.

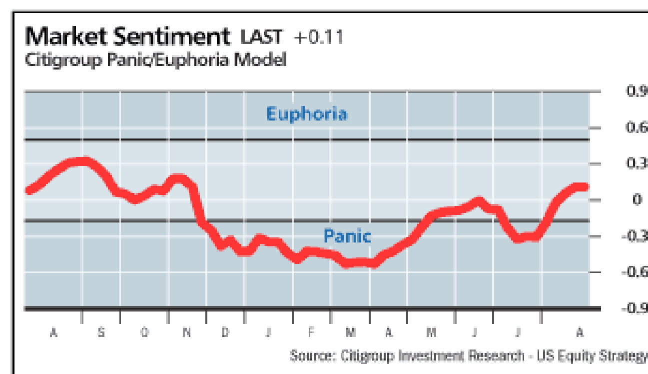
Valuations

There are a number of specific details of why returns may not continue to be quite as fruitful. The first is less compelling valuations. As you may recall in the past I've talked about the price-to-earnings or P/E ratio. Currently the S&P 500 is selling at a valuation of over 18 times earnings which is something of a premium to the long-term average of about 15. So the market is certainly somewhat expensive, but not terribly so.

Sentiment & Speculation

Much more disturbing than the current valuation levels is the expectation of investors or "sentiment" and the level of speculation that has suddenly appeared. The chart below neatly shows how sentiment has changed via the Citigroup Panic/Euphoria Model. While we're certainly not quite to the euphoria stage, we are just about where we were last year just before the real meltdown began and we can see how substantially sentiment has improved from March.

Sentiment matters because it can be a pretty reliable contrarian indicator. What most people expect to happen is usually wrong. The graph below bears that out. Sentiment was highest just before the big decline and lowest just before the big rise.



There are also some clear signs of speculation as well, which is usually another cautionary sign. Rather than talk about this in a vague, philosophical way let's look at four specific examples, Federal Home Loan Mortgage Corp., aka Fannie Mae, Federal

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National Mortgage Association, aka Freddie Mac, American Insurance Group aka AIG and General Motors. By now you've certainly heard all of these names, probably through gritted teeth accompanied by a scowl.

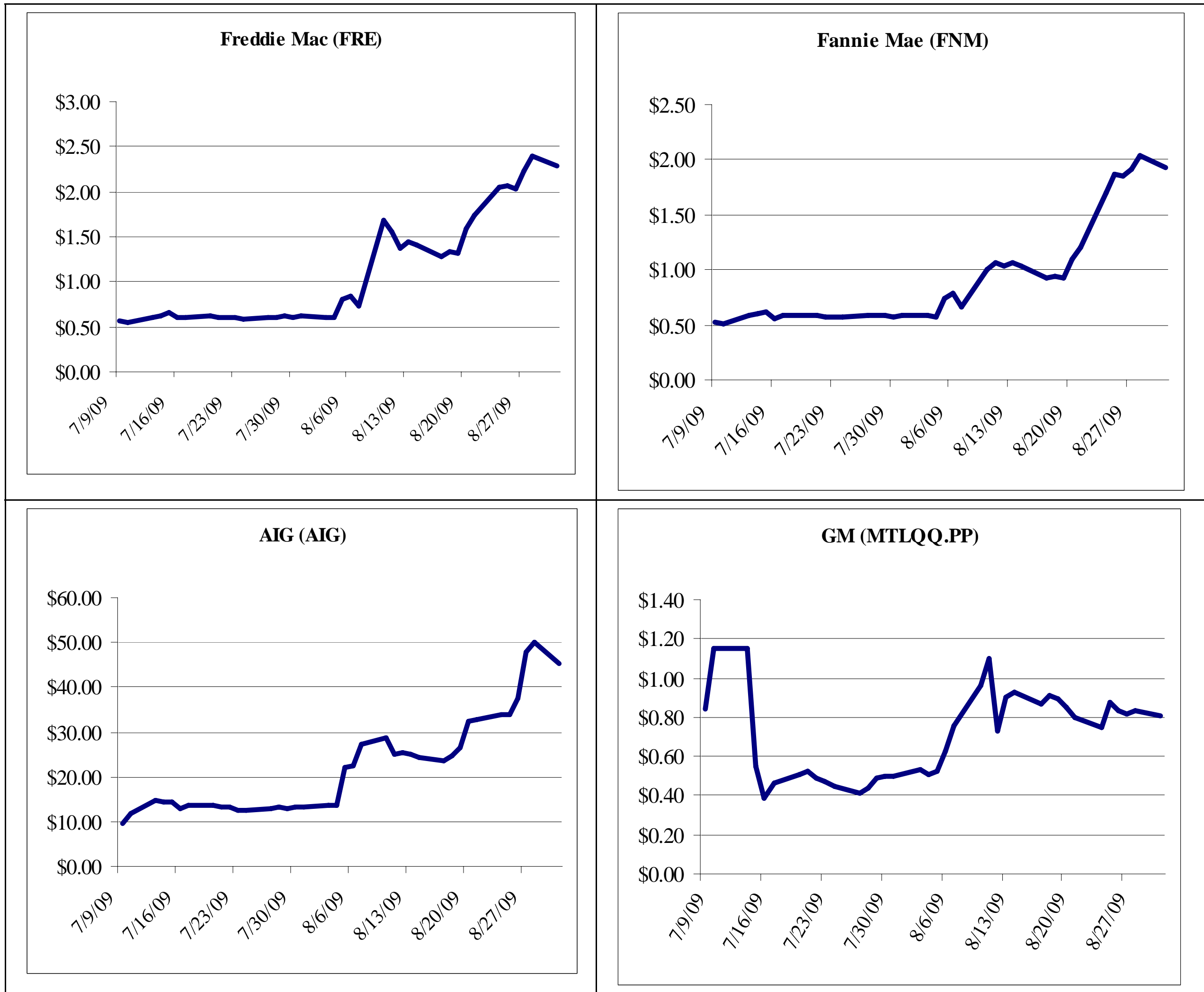
That these are troubled companies to say the very least is pretty well known. However, some "investors" (read speculators) seem to be uninterested in details like balance sheets. As of June 30, Freddie MAC had net assets attributable to its common shareholders of negative $122.6 billion. At Fannie Mae, the number was negative $138.1 billion. Between 1990 and 2007 the companies earned a total of just over $95 billion. So, their negative valuation overshadows all of their earning over nearly 20 years in their heyday. AIG had common shareholder equity of negative $35.4 billion. Just to clarify all of this, these companies together would have to earn almost $180 billion to achieve a net worth of zero. That is the equivalent of having half the stock value of Exxon,[2] the world's most valuable company, dumped into their lap. Yet, despite this fact that is obvious with the slightest amount of the most basic homework, all three of these stocks at least quadrupled in July and August.

While the above is incredible in and of itself, perhaps nothing represents the triumph of misplaced hope over reality like GM stock. As we all know, GM entered bankruptcy in June. A corporation (like a person) enters bankruptcy because the entity's liabilities are more than its assets. The value of a corporation's stock represents the value of its net assets plus goodwill. In bankruptcy then, the stock becomes worthless. In this case, the stock continued to trade because the entity continued to exist in order to liquidate the assets.

No secret was made of the fact that the stock and the entity are and always will be worthless. In fact, far from being a secret, both the company and the government have made great efforts to warn investors that the stock will be worthless and does not represent any claim on a new GM that may be formed with the assets. They have gone so far as to rename the entity Motors Liquidation Co. and changed the symbol to not include "GM." The stock could not be more clearly worthless. Despite all of this, people still buy the stock and, as the chart shows, it has nearly tripled in value at times.. As a recent New York Times article explained,

> *Industry analysts and regulators say two groups are buying Motors Liquidation stock: People who are confused and think they are getting shares of the new GM for cheap, and day traders or institutional investors hoping for short-term gains as others continue buying the stock.*

Let's simplify this. The people buying are those who don't know any better and those trying to take advantage of them. Obviously I've picked the most extreme examples, but there are plenty of others and the speculative excess in these stocks make the dot-com bubble look downright rational. I'm reminded of the quote from Peter Lynch, "most people spend more time selecting a toaster than where to put their life savings."



Economy & Stimulus

This is the part where I have to talk about the economy. I have to admit a little apprehension because one can't talk about the economy without talking about the various bailouts and stimulus package which gets one down the slippery slope of a political discussion pretty quickly. Hopefully we can sidestep much of that in favor of making fun of economists and other market pundits.

We know that the economy is at least perceived to be much better than it was last fall and over the winter. How much of that is permanent and attributable to government efforts will be left to time and academics to determine. That said, it's hard to believe the efforts didn't have any effect and they were likely somewhat substantial, at least in mitigating some significant damage in the short-term.

Two important questions seem to present themselves. The first is, did we just kick the can of economic pain down the road? It's hard to say, but it is difficult to believe that somehow everything is magically better and all of our problems are solved as the soaring market would seem to imply. An honest look at the banking sector for example would

certainly show that things are not nearly as rosy as the recent returns in that sector would indicate. To date through the current crisis about 100 banks (mostly smaller, to be sure) have failed. Recent official estimates put the expected number of defaults at about 400. It's hard not to think back a year to the woefully inadequate estimates of the write-downs that would be required at the bigger banks. There is nothing to suggest the problems are over at these bigger banks either. Ultimately, too big to fail is too big. These banks will be dismantled with either a market bang or regulatory whimper. There are also a lot of outstanding cyclical, structural and even theoretical issues to be addressed and resolved. This process will surely involve more surprises and pain.

The other important question is, now that we've let the genie of massive liquidity out of the economic bottle, will central banks around the world be able to get it back in? That the world's central bankers, who completely missed (and largely caused) the build-up of the huge speculative credit bubble and the resulting implosion, have suddenly been endowed with perfect clarity is probably not the safest bet. Even if they should somehow get the timing and amounts of the reversal of monetary easing mostly correct, we are left to deal with that great demon of policy, the law of unintended consequences. In short, there are a lot of needles to thread in order to get the unwinding of the stimulus correct. This is exacerbated considerably by the fact that the margin of safety has been eliminated. That is to say governments have virtually no bullets left should things start to go badly again.

I promised a few paragraphs back that we would avoid politics and focus on making fun of economists. Perhaps in the interest of politeness we can just focus mainly on mocking economic forecasts. Let's take the current economic downturn and see how the economist from the big banks and other forecasting services did in seeing this very large freight train coming. The Wall Street Journal ranked 51 of the nations leading economic forecasters on two measures, real GDP growth for 2008 and the unemployment rate at the end of 2008. The actual numbers were -.8 for GDP and 6.9% for unemployment.

So how did they do? Of the fifty one GDP forecasts only one actually got even the sign right and predicted a decline (-.4%) and the average guess was 2% with some going as high as 5%. Let's throw a bone to the guy who forecasted the decline and call him correct. On unemployment the closest anyone came to the actual number of 6.9% was 6.2%, more than 10% off with average guess/forecast being 5.2%, which is very far off.

So, of the 51 attempts at GDP we called one correct and of the 51 attempts at unemployment we called none correct, leaving us a total score of 1 out of 102. This is not an isolated incident. In his recent book, The Sages, Charles Morris writes:

> *As a check, I pulled a decade of economic forecasts from the White House's Council of Economic Advisors. The Council is staffed by top-flight, often Nobel-quality economists, and while they can have a political tinge, they rarely stray far from the professional consensus. I started with the 1997 report, released early in the year, when the dot-com boom was well underway. The Council thought the economy's maximum sustainable real growth rate was 2.5%, and expected 1997 growth of only 2%. The actual outcome, however, was stunning 4.5%. In their next report, in early 1998, the Council*

duly registered their astonishment at such a splendid 1997, but stuck with the expectation of slow growth, predicting a reversion to 2% for the new year. But the 1998 outcome, yet again, was more than twice as high as their forecast. They cautiously raised their forecast for 1999, but still seriously erred on the downside. By 2000, finally, they acknowledged a fundamental shift in national productivity, and sharply raised both their near- and medium-term outlooks – just in time for the dot-com bust and the 2001-2002 recession.

The Council's record during the Bush years was no better. They seriously overforecasted growth in 2002 and 2003, and once the economy was in full recovery mode in 2004, confidently expected that high growth rates had settled in for the long term. The 2008 report expected slower but positive growth in the first half of the year, as investment shifted away from housing, but foresaw a nice recovery in the second half, and a decent year overall… In other words, they hadn't a clue.

These are theoretically smart, well-educated, successful people. These are also not arcane numbers to forecast, but the core of any broader forecast. So how do so many smart people get such a core forecast so wrong? The short answer is they are playing a game that can't be won. The long answer will be provided in next quarter's commentary.

In conclusion, recent returns have been spectacularly good, possibly too good to be sustained. Valuations, while not wildly expensive, are at least somewhat above historical norms. There is a clear sense of growing speculation, which combined with overly rosy sentiment, provides a clear red flag. Finally, there is no reason to believe that increasingly optimistic economic projections will have any bearing on reality. Overall, there is to me a great deal of evidence, both hard and anecdotal, to suggest that risk is higher than the consensus believes.

[1] *Most indices tend to be narrow (the Dow Jones Industrial Average is comprised of just 30 stocks) and give greater weight to stocks with higher prices (the Dow) or of larger companies (the S&P 500). The Value Line Composite Index weights stocks equally without regard to price or capitalization. It also includes over 1,600, including all of the stocks in the Dow and S&P 500 of large, mid and small capitalizations. In short, it is an excellent proxy for the experience of the average investor in the average stock.*

[2] *The market capitalization of Exxon was $327,658,800,000 as of September 2, 2009 according to Bloomberg.*

Sources:

Indices cited above are as reported in The Wall Street Journal, both print and online, September 1, 2009. Fund averages cited are the respective Lipper Mutual Fund Indices.
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