

QUARTERLY COMMENTARY

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The Great Gamble

Fool me once; shame on you. Fool me twice; shame on me. That old aphorism certainly applied to the two giant common stock rallies over the past dozen years or so. In the late 1990s tremendous advances in internet technology spurred a fantastic surge in common stock prices to levels totally disconnected from the underlying valuation fundamentals. The investing public came to accept that there was no need to be bound to traditional valuation norms; this time was different. Unfortunately, the bursting of the dot.com bubble precipitated a stock market collapse. Almost all stocks declined, with the S & P 500 falling by about 50% from its peak in 2000.

Monetary authorities decided that economic and market conditions were so fragile that ultra-cheap money was called for. The Federal Reserve Board dropped short interest rates to multi-decade lows, and asset prices surged. Stocks rallied for years. Real estate prices exploded upward at rates unsurpassed in over a century. A few voices warned of developing bubbles, but they were largely dismissed. Stock and real estate investors were making money. The equity bear market from 2000 to 2003 was in the rear view mirror. Concerns about extreme valuations were again ignored. After all, The Maestro Alan Greenspan and other wise men were dictating monetary policy. This time was different.

Unfortunately, the bubbles again burst. Real estate values plummeted. Stock prices were cut at least in half for the second time in a decade. From late 2008 to early 2009 there were real fears that our financial system was so structurally damaged that it might freeze up and become non-functional. Monetary authorities and legislators were convinced that the only way to escape the next Great Depression was to pump unprecedented amounts of money into a rescue effort. They bailed out banks, insurance companies and automobile manufacturers. They gave money directly to buyers of homes, cars and appliances.

The Fed acknowledged buying over \$1.2 trillion (with a “T”) of mortgage-backed securities that otherwise had no market. The government abandoned even the appearance of free markets by openly buying shares in major financial firms. They are suspected of having also promoted bullish sentiment more covertly by strategically buying stocks when natural support was absent. That the money to do these beneficent things didn’t exist was apparently of little concern. We would simply write an IOU to future generations and hope the bailout worked.

To date that tremendous infusion of government money has slowed the collapse of real estate prices, encouraged reluctant home and car buyers and has turned most business trend statistics upward. While most economic analysts are encouraged that the depressed mood of the public has been elevated, few are yet confident that the improvement in economic statistics is sustainable without the artificial stimulus of government support. Unless the government abandons any semblance of maintaining a stable currency, they will soon have to halt the

infusion of rescue money and begin to withdraw funds. A critical question remains as to whether or not the economy has sufficient strength to continue its growth without government stimulus.

Questions about the sustainability of economic strength have certainly not slowed the advance of equity prices. The stock market rally off the March 2009 lows has been the strongest such bounce in more than half a century. While valuation measures of common stocks have not reached heights observed at the market tops in 2000 and 2007, they are virtually at all time highs but for those two bubble peaks. It is curious that we hear most analysts characterizing today's valuations as reasonable, even moderate. That is only true if the frame of reference is limited to recent years. Inasmuch as the most recent decade produced two of the worst bear markets in U.S. history and ended with a negative total return, it is absurd to consider the then prevailing unprecedented valuation levels to be relevant standards.

We have never been believers in the traditional "buy and hold" approach to investments. History has demonstrated clearly that long-weak cycles unfold periodically, which can produce negative stock market returns for a decade or more. We began to issue warnings against heavy stock ownership in the late 1990s, because investors were paying excessive prices for stocks relative to such value measures as earnings, dividends, book value, sales and cash flow. While not good short-term timing tools, valuations are excellent long-term gauges of stock market potential. Toward the end of the millennium, as investors were clearly caught up in the wave of dot.com enthusiasm, they ignored the more prosaic lessons of valuation history. Again in 2007, investors' confidence in historically low interest rates and the wisdom of the Fed overwhelmed any concern about excessive valuations.

In addition to our warnings about extended valuations, we argued in the late 1990s that levels of debt and the explosion of derivative use had reached a point that seriously threatened the economy and the investment markets. That caution was well founded, and we protected our clients from losses in every year but 2008. Even then, in one of the worst stock market years in U.S. history, we limited client losses to a minuscule 0.9% on average. We have accurately navigated a dangerous investment environment over the past decade.

That brings us to today. For the third time in a decade stocks are surging, and investment analysts are almost unanimous in their belief that prices are inevitably heading higher. We remain cautious for essentially the same reasons that have concerned us in the most recent two stock market surges. Debt and derivative levels remain no less worrisome and in some cases are even more severe. As explained earlier, stock valuations, while not as extreme as at the prior two market peaks, are near dangerous historic highs but for the bubble decade. Compounding these problems is the critical uncertainty about whether the economy can thrive absent continued government stimulus and whether the remnants of the economic collapse will lead to a lasting profound change of social mood. Therein lies the great gamble for stocks.

The current rescue plan has been crafted by those same monetary authorities and legislators who failed to see the crisis coming and who downplayed its potential when the first signs were evident. Why should we have confidence that government will get it right this time? Fixed income securities always offer an alternative to equity ownership. There are, however, no easy answers in that area either. The Federal Reserve has reduced risk-free short-term interest

rates essentially to zero, deliberately forcing investors to accept risk to obtain any return. The Fed has succeeded in promoting risk taking over the past year, and the greatest rewards have accrued to those willing to accept the greatest risks. Many junk bonds defaulted when the economy imploded two years ago. Those that survived, however, returned over 60% over the past twelve months. The worst credits among junk bonds returned double that amount, a very productive speculation.

Interest rate direction in the year ahead is highly uncertain. It will largely depend upon whether inflation or deflation prevails. There are strong forces pulling in both directions. I will be addressing that subject in much greater detail at our May 7 conference. I hope all of our clients will register and join us for that event.

While we could make a case for either rising or falling interest rates, there is far more room above current rates than below. With either direction possible, there is considerably more danger to portfolio values should rates rise than there is reward should they fall.

Bond investors have been protected over the past year by the government's implied guaranty of nearly everybody. That support is almost certainly nearing an end. Before the government rescue programs began, corporate bond holders became increasingly worried about the potential for default, even among supposedly high quality credits. That potential will return if the economy fails to grow in the absence of government support.

Municipal finances have deteriorated badly despite a large dose of rescue money. Just this month Moody's assigned a negative outlook to the creditworthiness of all local U.S. governments. This is the first time in over 100 years that Moody's has issued such a blanket ratings warning.

Investors can gamble for yield on corporates or munis, but a single default could cost more than the yield on an entire portfolio. Investors can gamble on interest rate direction, but if rates rise, bonds could easily produce negative returns, as long U.S. Treasuries did this past year. If the flood of promised new money in the various rescue packages should lead to rampant inflation, the return on all but the shortest bonds could be negative. If investors choose not to gamble, they barely get paid, but they retain flexibility to make new choices as conditions change. We are in an unstable condition that will certainly change, potentially quite dramatically.

On the equity side, there is no way to know how high the current rally may rise. That was likewise the case before the market peaks in 2000 and 2007. Recognizing the debt and derivative dangers on top of excessive valuations, we chose in the prior instances to remain in a very conservative stance and await more attractive conditions. Ours proved to be the correct decision in each instance. We see largely the same situation today. While we cannot guaranty that we will again be right by paying more attention to fundamentals than market momentum, we strongly believe that patience will again be rewarded. That view is buttressed by the fact that our equity selection process, which has selected stocks with far better performance records than the overall market for a quarter of a century, is finding no attractive stocks to buy in the current environment.

There are times when the wisest course is not to gamble but rather to protect assets and keep them available for upcoming opportunities. We did exactly that before the last two major stock market peaks. That restraint enabled our portfolios to outperform the S & P 500 through the new century's first decade by more than 60 percentage points. We strongly believe we remain in an environment in which similar conservative action will protect portfolio assets and will eventually maximize portfolio returns.

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