

INVESTMENT REVIEW AND OUTLOOK

ANYONE WHO ISN'T CONFUSED DOESN'T REALLY UNDERSTAND THE SITUATION.

Edward R. Murrow

Third Quarter and Nine Month Review

In a few short months, investor sentiment has undergone a dramatic shift. For much of the first half, the fear of a devastating and permanent loss of capital completely overshadowed the fear of missed investment opportunities in the minds of investors. The two sentiments normally act as alter egos, but as recently as midsummer there was little sign of the risk taker in the investors we spoke with. With the global financial system only recently back from the brink of collapse, the fear of further losses was an understandable frame of mind. In hindsight, the first leg of the broad rally that began in March was as much about the fear/greed gauge simply backing down out of the red zone as it was about the stabilization of the global economy. The mere abatement of forced/panic selling in combination with short covering and some tentative buying was enough to set off a sudden and violent rally. More recently, the undeniable appearance of economic “green shoots” and the ability of companies to beat very bearish earnings expectations have helped to propel equities still higher in the third quarter. As we discussed in our last letter, the removal of the Armageddon scenario and reversal of the panic trade caused a sharp revaluation of stocks, particularly the stocks of the most financially challenged companies. ***As a result, returns this year have been heavily skewed toward the riskiest sectors and securities.*** Small caps and mid caps have dramatically outperformed large caps in the third quarter and year to date periods. In the initial post crash rally, stocks priced under \$5 per share outperformed those priced above \$50 per share by the widest margin in history. Year to date through September, the equally weighted S&P 500 has returned nearly twice that of the capitalization weighted S&P 500. ***And if one accepts Warren Buffet's portfolio as a proxy for the blue chip, high quality segment of the market, it is interesting to note that Berkshire Hathaway stock is up just 3.5% through September.***

The best performing sectors in the third quarter and year to date periods included technology, consumer discretionary and financials. However, peeling back the onion one finds further evidence of the rally's speculative nature. Among the top performing sub-sectors this year have been such industries as home builders, tire and rubber, retail, apparel, restaurants, lodging and home furnishings. ***Finally, gold, while lagging the major stock indices on a year to date basis, continued to perform well and is one of the only asset classes in the world hitting all time highs as of this writing.***

Outlook

The current economic and investment environment is as perplexing and challenging as any in history. There is a good deal of talk about the “new normal”, a recently coined phrase that has quickly become a part of the financial lexicon. But does anyone really know what it means? Plausible forecasts can be made for a “V” shaped recovery, a double dip recession, or a Japanese style deflation among others. Higher taxes, stubbornly high unemployment, a restrained consumer and a more activist government are among the more worrisome potential features of the new normal. ***Meanwhile the fundamental tug of war between the deflation and inflation scenarios continues, transcending any debate over the size or shape of the recovery.***

While the secular problems remain substantial, the key *cyclical* point is that an economic recovery of some sort is probably underway. This alone should be supportive of equities for the time being. As we pointed out last quarter, as day follows night, recovery follows recession. History is not on the side of those making the case for *no* recovery. It is true that the problems are unprecedented in scope but the policy responses have been equally unprecedented. To begin with, central banks around the world are essentially daring investors to move into riskier assets by keeping short term interest rates abnormally low. These same low rates not only enhance the appeal of stocks over bonds, but also improve the profitability of the banking and overall corporate sector, particularly given the high levels of leverage that exist. ***Aggressive cost cutting and the weak dollar are likely to further boost the profit outlook for the next six to twelve months.*** Of course, in the final analysis, one person’s cost cutting is another person’s job loss. However, an earnings turnaround is a necessary first step toward an eventual rebound in revenues and, ultimately, hiring. Meanwhile, many comparisons have been drawn between Japan in the early 1990s and the U.S. today, but the behavior of their respective currencies could not be more different. In the early 1990s, the Japanese yen soared relative to the U.S. dollar, deepening their deflationary crisis. The cheapened U.S. dollar has its own downside, but in the short run it should stimulate growth and give a leg up to globally geared U.S. corporations. For now, the path of least resistance for equities is up. The first major test for stocks is not likely to come until monetary policy expectations begin to shift from easing to tightening, something we don’t foresee for at least the next six months. ***Ironically, the much bemoaned weak recovery scenario probably represents the ideal outcome for both the stock market and the economy.*** A strong or “V” shaped recovery might force the Fed’s hand, causing them to prematurely raise rates in an effort to fight inflation. This, in turn, could cause the recovery to abort. ***At this juncture, the Fed’s dismount is the critical part of its program. They need to stick it.***

We quoted Edward R. Murrow on confusing situations at the beginning of this letter. His quip seems particularly germane as we think about the investment issues of today. What is the appropriate portfolio strategy for our clients, given the major adjustments and new risk factors that the notion of a “new normal” implies? It is an evolving strategy, but the following themes and judgments are reflective of our best current thinking:

- Maintain a prudent and balanced approach. A return to the age old concept of a “margin of safety” with respect to portfolios is advisable. ***Many investors came to think of diversification as synonymous with the margin of safety, when in reality it was only one of its component parts.***

(The mega college endowments come to mind). Cash, TIPS and high grade corporate bonds still make sense within the context of balanced accounts.

- Be flexible. One must be nimble and alert to the possibility that the current upturn is merely a bear market rally. Many such rallies occurred in the 1930s and 1970s. Profit opportunities can be substantial, but a dogmatic “buy and hold” strategy does not work.
- Hedge against inflation and currency devaluation. Maintain significant gold, hard asset and emerging market exposures.
- Focus on sustainable income streams. In an environment characterized by weak growth and recurring deflationary risks, sustainable income becomes a scarce resource. This would include high grade bonds, secure common stock dividends, and MLPs where applicable.
- Within the equity component, emphasize high quality, globally geared large cap equities with good dividends. In a world where few asset classes screen as historically cheap, this one stands out. As the stock market rally matures, the outperformance of small caps should fade. The larger cap companies have better access to credit than their smaller cap counterparts, are more exposed to faster growing emerging economies, and are beneficiaries of a weaker dollar. Revenue growth will be at a premium and companies who are able to produce it will be highly prized. Global large caps fit this bill.

Communication is more important than ever. In these uncertain times asset allocation targets and risk profiles are likely to vary greatly from client to client. We encourage any clients we haven't spoken with, particularly our non-institutional clients, to give us a call to discuss investment policy, asset allocation and benchmarks.