

Commentary and Outlook July 2010

Equity markets began to decline dramatically from late April until the first week of July when various measures of negative investor sentiment exceeded levels not seen since the low in the market on March 9, 2009. The S&P 500 declined 16% from April 23 to July 2, as investors became extremely concerned about the slowing in the domestic recovery and that of the Eurozone. As the market declined, the chorus of negative commentary grew louder and more desperate feeding the terror-based decision making that reduced risk assets. It is clear that memories of the market crash in 2008 through early 2009 are fresh and investors shortened their investment horizons swiftly in the recent quarter to avoid a replay of that painful interval. At the same time, bonds, especially Treasury bonds, rallied strongly with the ten year US Treasury Note declining from a 3.99% yield-to-maturity on April 5th to 2.93% on June 30. The low yields on Treasury securities reflect more than a flight to quality over concerns about the sovereign debt crises in Europe. They appear to discount deflation and economic contraction as investors attempt to avoid further asset value declines. The rapid risk reduction caused indiscriminate liquidation of many higher return potential assets, including below investment grade bonds that had performed so well until late April from March 2009. Correlations of equities were very high, with little differentiation based upon fundamental financial strength, earnings potential or valuation thereof.

The S&P 500 annualized rate of return for the decade ended June 30, 2010 was -1.59%. The MSCI EAFE, an index of developed market equities, was up 0.59% a year in the decade. The best performing major asset class was emerging market equities for the ten year period ended June 30, as the MSCI Emerging Market Index registered a 10.34% annualized gain. Next were domestic REITS (real estate) that produced a 10.06% gain as measured by the S&P US REIT Index. Not surprisingly, given the very low bond yields at June 30, the Barclays US Aggregate Bond Index produced a 6.47% per annum rate of return for the decade.

History strongly suggests that rates of return on equities after such negative decades are significantly positive, as noted in our last quarterly letter. This is certainly plausible given the price-to-earnings ratio of the S&P 500 is now about half that of the multiple it had a decade ago and interest rates are half or less than they were then. Of course, this next decade may be different, but to the extent that financial markets and economic decisions reflect behavior, assuming that past patterns will change materially can be risky. It is axiomatic that there will be little obviously compelling current data upon which to base a positive case for equities after such protracted disappointing experience. Indeed, there typically is ample evidence to support arguments that the worst is yet to come and that further economic deterioration must occur to clear the excess debt and curtail profligate spending and borrowing by governments in the developed world.¹ Debt liquidation in the private sector continues and will clearly slow economic recovery. It appears that political considerations reduce the likelihood of additional government economic stimulus or maintenance of current tax rates. In such a gloomy setting it is difficult to see earnings growth, except for that derived from activity in emerging market countries. However, the market may well be valuing equities with little expectation of even average earnings growth in the mid single digit range. Our meetings with many equity managers suggest that earnings prospects and valuations of many companies are attractive and while macro conditions certainly matter, many of these opportunities are idiosyncratic and less dependent upon a robust recovery. A prime example of this is the information technology sector where valuations are as low as they were in 1995. While it may be tempting to try to actively position a portfolio's exposure to avoid equity or other risks, the volatility witnessed recently suggests that doing so could be costly. It is likely that most of the commentary that you will see this quarter will suggest an equity market that is "range-bound," one that will be quite volatile and one in which a buy and hold strategy is naive. Yes, clever traders can reduce volatility by hedging techniques and the portfolio has representation of such managers in the less correlated category that are both long and short stocks, but unless there is a renewed economic contraction, or double-dip, equities appear to offer reasonable risk/reward characteristics.

¹ It is notable that emerging countries have surplus financial assets and little debt and are developing consumer-based economies, thus appear to present a multi-year opportunity for growth.

The clear weakening in various government and private statistics that gauge economic activity in late April though the present have caused palpable fear among many commentators and investors. When fear and risk aversion are palpable, it is easy to be bearish.² Emotions should never dictate action when investing, however. Such fear has ignored very strong corporate financial condition, improved operating leverage and earnings progress until early July. In a perhaps unsurprising reversal given the steep sell-off for two months, stocks have responded positively to early corporate second quarter earnings reports that have helped the S&P 500 to a 7% gain in July. While there are enormous structural problems confronting developed nations from stubbornly high unemployment, still high private debt and growing government debt, there remains the probability that the domestic economic recovery will continue, albeit at lower rates of gain and that relatively low valuations of strong companies can produce returns that exceed those of bonds, even accounting for the generic risk of equities. It is worth noting that the earnings improvement has been more dramatic than any cyclical recovery over the past thirty years.³ Risk reduction within corporations has been significant, which is very good news for investors. Credit markets have reflected concern about a slowing economy, although are well above the low levels they reached in 2008 and early 2009, relative to Treasury yields.

Price inflation continues to be a more distant risk than we thought in the first quarter, as concerns about deflation have again taken the fore with the slowing rate of economic activity. It is likely that the Federal Reserve will maintain very low short-term interest rates until there is a recovery in employment. Indeed, the Open Market Committee of the Federal Reserve Board may initiate more aggressive action to provide credit to the economy. We have noted that the output gap, or underutilization of capacity and the high unemployment rate will restrain price increases. However, the potential for material price increases remains should housing inventory be reduced and employment improve over the next several years. The potential for physical commodities to increase significantly in price is also high given the constraints of materially increasing capacity to meet incremental demand in most important sectors. The eventual transition from very accommodative monetary and fiscal policies to those focused on price stability is likely to be dramatic, with higher bond yields.

As we noted in our last quarterly letter, emerging market equities continue to represent an excellent opportunity for long-term growth, although we believe that their performance since their low point in November 2008 has corrected much of the undervaluation and that they are now fairly valued, especially relative to large capitalized multi-national company stocks. Both broad equity sectors represent strongly financed enterprises that can capture growth in the faster growing regions of the world.

² July 30, 2010 news release excerpt: "Real gross domestic product -- the output of goods and services produced by labor and property located in the United States -- increased at an annual rate of 2.4 percent in the second quarter of 2010, (that is, from the first quarter to the second quarter), according to the "advance" estimate released by the Bureau of Economic Analysis. In the first quarter, real GDP increased 3.7 percent."

³ An excerpt from Bob Turner's August letter: "About 300 of the S&P 500 companies have released their earnings to date, and about 77% of them have beaten Wall Street analysts' estimates, according to Thomson Reuters. That's the highest percentage of positive earnings surprises since Thomson Reuters began compiling the data 16 years ago. Earnings per share have risen an average of 35% year-over-year, compared with a rate of 27% that was expected by analysts just a few months ago. And companies aren't just reporting better profits, but three out of four of them are also beating revenue targets as well."