



## 2009 First Quarter Report – Bill Matthes

It was an absolutely brutal quarter that ended on an up note. The S&P 500 index declined almost 30% in the first nine weeks of the year, but had a spectacular rally in March to cut the full quarter's decline to 11%. As we entered the second quarter, the bulls were still in charge and the market advance continued.

The market's nose dive at the beginning of the year was perfectly understandable given a litany of bad economic news, poor earnings and consumer pessimism. The March rally came after financial stocks showed some stability, home sales ticked up a bit and the government passed a massive stimulus plan. For the bears, March was nothing more than a bear market rally, a little rest before the market continues its mauling. For the bulls, March was a successful test of the October lows meaning the bottoming process appears to be well underway.

Neither a quick market recovery nor a continued decline would surprise us. Most companies should be reporting terrible first quarter earnings and their projections for the rest of 2009 are unlikely to be rosy. Unemployment should be rising, there should be more bankruptcies and it is too soon to see the effects of the stimulus packages. But, the market knew that.

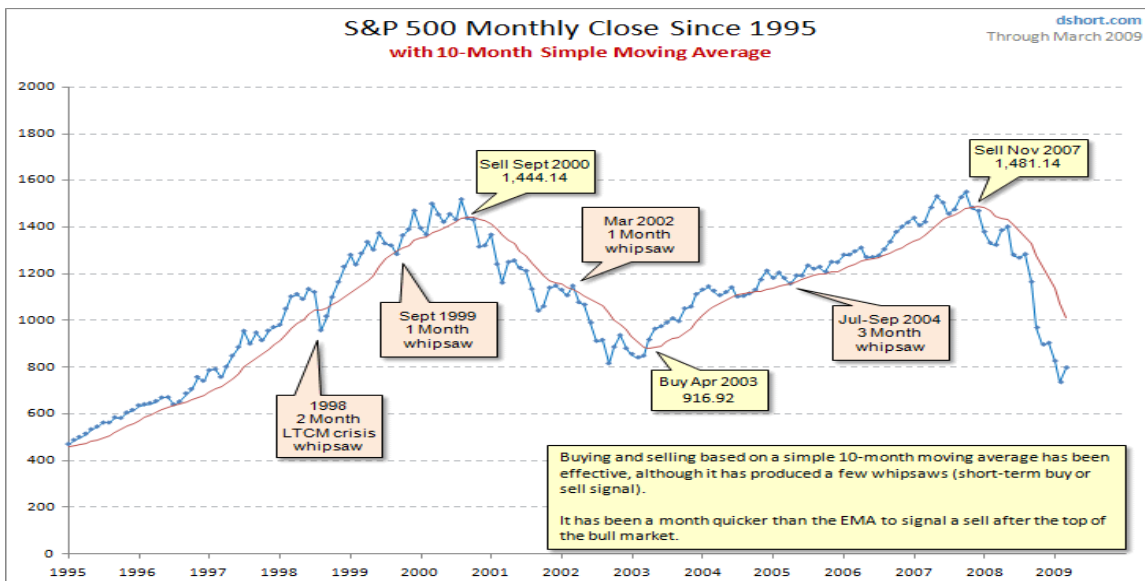
What will move the market from here are the results of the stress tests on banks, any sign of strength in the economy and how much of the trillions of dollars that is on the sidelines decides to tiptoe back into the stock market. We don't need good news for the market to go up, we just apparently need news that is better than what we thought it would be. We don't need a lot of buying to get a solid recovery; we just probably need people to stop selling. There are two parts to this bear market, a financial panic and a recession. The market's partial recovery probably means we are in the later stages of the financial panic. Now we can deal with the recession.

### The Death of "Buy and Hold"?

When I went to school, I was taught that the only proven way to make money in the stock market was to buy a diversified portfolio of better than average companies and hold them for as long as possible, a strategy generally known as "Buy and Hold". My professors taught me this lesson over thirty years ago and it has served my clients and myself well for all that time, as it has almost every successful equity investor I have ever known or have heard of.

Except that now I am hearing that “Buy and Hold” is dead. I have been unable to learn the exact date of its demise, but I gather from the market experts who confidently make this assertion, that it was sometime prior to the current market correction, the pain of which they were able to largely avoid by using the new science of “Quantitative Asset Allocation.” You can only imagine how silly I felt when I realized I was using a dead strategy and had missed the new thing that had such an impressive name.

To try make up for my lack of in-service education I went right to the computer. I got the latest books on the subject from Amazon and took a tour of the internet to find out what I was missing. It turns out “Quantitative Asset Allocation” is just a fancy name for “Market Timing.” I dismissed that practice of moving in and out of markets based on statistical rules many years ago, so I tried to approach its latest incarnation with an open mind. The best case I could find against “Buy and Hold” was in *The Ivy Portfolio* by my fellow UVA alumnus Mebane Faber. He offers the following proof that stocks are best bought and sold like pork bellies instead of being held like family heirlooms. After some research, Mr. Faber concludes that a 10 week moving average is the best test of whether we are in a bull or bear market. So long as the monthly market close is above that magic number, stocks are to be held. Should they violate the moving average, they are to be sold in favor of cash until the next bull market begins; an event confirmed by a market close above the 10 week average.



Extensive back testing of this “quantitative” approach to investing yielded spectacular results from 1902 through 2008. He found that the market was in an uptrend 69.88% of the time. Using his simple moving average rule, if you just invested during bull markets, you would have had an average annual rate of return of 14.42% for the time you owned stocks. That performance is much better than less than 10% the market has returned for the past century and spectacularly better than the messily 3.03% return you would have earned during the 29.12% of the time the system told you to hold cash.

We all knew that if we could just devise a system to be in bull markets and out of bear markets we could have our cake and eat it too. Finally, here is proof that it is not only possible but widely profitable. Or is it?

If we had been bright enough to follow this disciple, we would have been in the market most of the time and out in the worst of the bear markets, but what was the real average rate of return for all the time? About 70% of the time you earned over 14% but about 30% of the time, you got whatever the money market or cash yielded. Money markets yield almost nothing today, so why would you sell something with an average yield of 3% to get less than 1%. Still, that minor difference in yield is nothing compared to the pain of suffering a brutal market correction. Most people would accept a slightly lower rate of return for less volatility.

Let's be generous and assume that over the past century the average money market yield has been 5%, which gives us a total return for the entire holding period of:  $14.42\% \times .6988$  plus  $5\% \times 2912\% = 12\%$ . That's a little better than the 11% the "Buy and Hold" investor got, but hardly spectacular.

Now the real fun starts. As you can see from the above chart, over the past 13 years the systems has given two good buy signals, two good sell signals and four "whipsaws" or false signals that required a reversal of the trade in one to three months. Great, here is a system with the exact same probability of being right as a flip of a coin!

Two buys, two sells and four quick in and outs (or out and ins) means you were turning over your portfolio twelve times in 13 years, or almost once a year, paying taxes and transaction costs on every turn. Now the odds are against you and we haven't even gotten to the problems of actually executing the trading strategy or what happens if there are just a few more whipsaws (note how many close calls there are on the chart).

Far from being the definitive proof that "Buy and Hold" is dead, the study makes it pretty clear to me that the alternatives are vastly inferior and their proponents lack training in elementary statistics. That's something I have always assumed but was unable to prove until now.

**Whether you call it "quantitative asset allocation" or "crystal ball prognostication" it is utterly futile and generally self-defeating to attempt avoid market corrections.** More importantly, it is of little or no interest to the long-term investor. For us, there is only one question worth asking that would change our investments: "Has there been a fundamental change in the world economy that requires us to conclude that we are entering a prolonged period of subpar return for equities?"

## Is Bear Different?

Over the past ten years the stock market has had one of its worst returns in history, but a good part of the market's dismal performance over the last decade has to do with bad timing, not the fundamental performance of the market. The compounded rate of return of the S&P 500 for the past ten years is a negative 3.0%, but it just so happens that the market was near a top in 1999 and we have just had one of the most brutal drops in history. Use a slightly different start and stop date and you get very different results.

These are the annualized returns for the S&P 500 for a decade over the past ten years:

1998-2008 -1.43% LOW	1993-2003 10.72%	
1997-2007 5.86%	1992-2002 8.71%	
1996-2006 8.35%	1991-2001 11.95%	AVERAGE 9.76%
1995-2005 9.02%	1990-2000 16.05%	
1994-2004 12.01%	1989-1999 16.36% HIGH	

This record is remarkably consistent with the returns the market has experienced for the past two centuries. Siegel, *Stocks for the Long-Run*, reports 10 year returns for the market from 1802 to 1992 had a high of 16.9% and low of -4.1% with an average of 9.9%. There is nothing in the recent performance of the stock market to make us believe market conditions have changed dramatically.

## What Could Change Everything?

There are two great threats to equity investors that would require us to change our investments; one is hyper-inflation and the other is hyper-deflation. Of the two, deflation is most damaging to equities. Deflation is what we are experiencing today in a relatively mild form, but it is what Japan has experienced for over a decade and a half, making their stock market one of the worst performing in the world. Deflation is the rapid and continuous loss in value of assets. It is wealth destruction on a grand scale. Deflation is a recession that turns into a depression that can last a decade or more.

To believe that stocks are not a good value at these levels you have to believe that we, and therefore the world, are going into a deflationary depression. We live in a world of hyperboles, but anyone who says we are in a depression now doesn't understand the definition of the word. Depressions are 20% plus unemployment, not 9%. Depressions are world economies that are contracting rapidly, not just correcting. Depression is years and years of pain, not a few months.

A depression could happen but we appear nowhere near that now. To get to depression levels you have to believe that the ten trillion dollars the world's governments have thrown at our current economic problems will be ineffective. You have to believe that the hammer is yet to fall on the world economy, which is far worse than anything we have seen yet. It could happen, but it is a highly unlikely event, that we do not foresee.

If you are absolutely sure that there will be a long, worldwide depression there are only two assets worth owning, cash and long-term treasury bonds. Everything else will likely lose you money. In a depression cash will at least hold its value and even increase in buying power as the price of everything else declines. The only better investment will be long dated treasury bonds, which will be one of the few things to increase in price as interest rates go to near zero. Three percent for a thirty year government bond will look like a great bargain when your house is worth less every year and cash is yielding nothing.

There are two risks if you decide to set up your portfolio for a depression. The biggest risk is that if you are wrong and this is just another recession, you will miss the recovery while expecting the next crash. If you miss just one recovery in a lifetime of stock investing you can change the odds of owning stocks from strongly positive to negative. That's the real risk in going to cash, which most people wrongly see as a risk free transaction. Most of us will not live long enough to turn the odds back in favor of owning equities if we make the mistake of selling near a market low and missing the recovery. Investing is not about trying to predict the future. Investing is about keeping the odds in your favor.

The other risk of setting up your portfolio for a depression is that you will almost certainly lose money on your long-term treasury trade if the economy recovers. A recovery will almost certainly bring higher interest rates and lower bond prices. You'd have to be awfully sure of your credentials as an economist to make a bet on long treasury bonds when yields are near all time lows, the government is running record deficits and the Fed is printing money like a drunken sailor. But, that is exactly what you have to do if you think there will be a depression.

This leads us to the other great macro event that could cause us to change our investment philosophy, hyper-inflation. There is no risk of inflation while the economy is contracting, unemployment is high and saving rates are increasing. In today's deflationary environment any hint of inflation is considered good news, not bad. A pickup in home prices, an industry that can raise prices or better wages are manna from heaven in a deflationary recession.

Inflation only becomes a real problem if the economy begins to recover, but the government keeps spending too much. It's a real risk, but one we probably don't have to worry about for quite awhile. There is no reason to sell stocks now if you think there will be inflation down the line. During the first stages of inflation, stocks typically perform very well as asset prices rise and the economy expands. It's not until much later that investors figure out that hard assets are a better deal than soft stocks and prefer oil and gold over dividends and earnings.

We know how to protect a portfolio from the later stages of hyper-inflation, but it's certainly nothing we would do today. Nor would we recommend investors take the risk of positioning their portfolios for depression, but we know how to do it if our client's insist. The point is that both strategies are very risky bets on unlikely events, which we do not think are warranted given today's economy.

It seems to us that the less risky strategy is to position portfolios for the recovery in equity markets that will probably come long before the recession is over and most likely when things look the bleakest. That means keeping a stable asset allocation between stocks and bonds, but weighting portfolios more towards cyclical and growth stocks that are most likely to outperform in the early stages of a recovery.

### No Place To Hide

Bonds have been anything but a safe haven in this recession. The panic in the credit markets has caused bond investors nearly as much pain as stock investors. Mortgage and real estate related issues have been crushed for obvious reasons. The default of Lehman Brothers and bailout of AIG and Citigroup have left nearly all financial related bonds suspect, despite the fact that so far, government policy has been to protect bond holders of all but the sickest corporations.

The government's hesitation to give bond holders a haircut in a bailout is nothing more than self interest. In the United States (unlike Japan), corporations hold very little equity in each other, but they hold a lot of bonds. Bond defaults put pressure on balance sheets of the same banks, brokers and insurance companies they are trying to save. When bonds go into default the credit markets seize up, other companies can't roll their debt and more institutions become insolvent. The government can not allow a chain reaction of bond defaults in the middle of a financial panic.

Still, investors believe there is a high degree of default risk in bonds. Any bond with real or perceived credit risk is trading at a huge premium over treasury yields. Whether or not these high yields are justified depends on how long and deep the recession will be. There has been some decline in corporate bond yields, but the bond market is still pricing in extraordinarily high default rates across a wide number of industries.

The "risk premium," (the yield of a bond over the risk free treasury return) is supposed to reflect the risk of default. Unfortunately, in a market where the balance sheets of all the natural buyers of bonds are stressed, bond prices may have more to do with the laws of supply and demand than risk of default. If it wasn't for the fact that we think the stock market is even cheaper than the bond market, we'd be bigger buyers of corporate bonds at today's high yields.

In summary, the quarter fulfilled everything we described last time as “The Investor’s Paradox.” There was a terrifying decline followed by a powerful rally just when things looked the bleakest. The world’s economy is flat on its back, but fiscal and monetary policies by governments all over the world are administering massive doses of medicine. If this treatment fails, we’d be perfectly willing to change our investment philosophy, but given the current investment climate, we believe the risk of missing a market recovery far outweighs the risk of a further downturn in the market.

William Matthes

The information herein has been obtained from sources believed to be reliable, but we cannot guarantee its accuracy or completeness. Past performance is no guarantee of future results. Neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Westport Resources Management, Inc. is an Investment Advisor registered with the SEC.