



CALM AND COLLECTED

So far this year the markets have been able to keep their composure amazingly well, despite events that would be expected to shake them. In contrast last year at this time, we had seen surging corporate profits fuel a 20% advance in the stock market and a sharp increase in interest rates, but that was quickly followed by fears of a double dip recession and the markets gave up all their gains and then some.

This year's surge and purge was only about half as much as last year's, despite news that the bulls argued should have ricketed the market higher, and the bears were sure would set it on its ear. Corporate profits continued to come in better than expected, but unemployment remained stubbornly high, and the economy again showed signs of weakening. The Fed announced it would stop quantitative easing, thus taking the training wheels off the bond market, but interest rates remained near all time lows. Greece threatened to bring down the European Union. The European Union threatened to bring down the major European banks. Everybody blinked and they kicked the can down the road. The economic anarchists in the House of Representatives are threatening to throw a Molotov cocktail at the U.S. government if they don't get their way, but we are assuming they'll also just kick the can, not light a match.

Oil prices spiked and then sank like a rock. The dollar got killed and then became the safe haven of choice. China's housing bubble finally began to burst, but their government seems able to support their banks. There's no wage inflation and US corporations are flush with cash, but health care costs continue to burn a hole in profit margins. A Republican House means there can be no new big spending programs, but the ones we have are eating up 140% of what we are taking in. We finally killed Osama Bin Laden, but we are braced for a counter attack. The banks are still posting major losses from their mortgage deals three years after the fact, but they have the capital to do it, so they remain solvent.

Maybe the movie just isn't as scary the second time you see it, or maybe they've been giving out free valium samples on Wall Street, but for whatever reason, the markets have been taking all this news in stride. Maybe this is the "New Normal" PIMCO's Bill Gross has been talking about, or maybe the markets are just too waiting for the real fun to begin in the second half. I don't know. The bulls and bears have had plenty of reasons to support their cases, but neither has done so convincingly.

In the first half we lightened up on, or didn't add to, energy and commodity stocks when they were going to moon. That saved us some major pain as the year went on, and what was hot became cold. We took that money and added to our positions in healthcare, technology, and financials because they were lagging the market. By the end of the second quarter, it looked like health care was turning around, but technology and financial stocks remain in the dog house. We are patient investors.

Other than the relatively minor rotation from commodity and cyclical stocks to the more mundane consumer and health care names, the market hasn't offered a lot of opportunity to outperform or underperform the averages; unless you were looking for a sustainable trend, in which case you had a good chance of losing your shirt. We don't do that, so most of our accounts followed the market, which is to say, net-net, haven't done much so far this year.

We are neither discouraged nor encouraged by this performance, or lack thereof. Our job is to try to match the market most of time, do a little better when a market bubble bursts or there is a major cyclical recovery. If we do that well, we should give our clients a smoother ride and superior long term returns. Here is why we think we can do that.

CASE CLOSED

A recent academic study has proved that value investing is the only market strategy ever tested that not only reduces the risk of owning stocks, but also improves performance. The results were so overwhelmingly in favor of value over growth that the study was named "CASE CLOSED." That's big news for several reasons.

First, it's not supposed to be that way. Academic theory had held that markets are efficient and the world is fair. If you buy a portfolio of high-risk fast growing companies, you should be compensated for taking that additional risk by getting a higher return. The fact that all recent studies have shown that this is not the case, that lower risk stocks give superior returns, is contrary to "the efficient market hypothesis" that has been the cornerstone of modern portfolio theory for decades.

Second, if low risk stocks give better returns than the popular high flyers, most of what passes for wisdom on Wall Street is just plain nonsense. The theory that you can make the most money by buying the fastest growing, most innovative companies is just plain wrong. Selecting stocks based on their recent performance is counterproductive. The more popular an investment is, the less well it is likely to perform.

And finally, it means that what we have been preaching for years is right. Contrarian investing offers the best opportunity to beat the market, and get a smoother ride along the way, by buying what the crowd hates and selling what they love. Buying a company at the right price is more important than estimating how fast a company will grow because value can be calculated, but future growth is only a guess, and all too often a bad guess.

CLOSING THE CASE

Most investment philosophies sound great, but they are either untested or can't be tested. Pinning down a quantitative or computer generated trading system, so you can test it is like chasing your tail. Yes, they back test the model, but the model is always changing. As soon one doesn't work, a new one is devised from back testing to fit the new reality. The result is something we know worked in the past, but may or may not work in the future. That's just not science.

Science is a long term study using accepted sampling techniques, which is published for peer review and submitted for independent replication of the results. "Case Closed" by professors Robert A. Haugen and Nardin L. Baker closes the case on value versus growth and momentum investing. They studied every U.S. company they could get data on (677 to 6382) from 1963 to 2007. They analyzed the monthly performance, trend factors and measurements of value and growth for each stock and computed the effect each of these factors had on future stock performance.

Their conclusions are as follows:

"The stocks with the highest risk [most expensive, most price momentum, fastest growing] produced the lowest returns – and stocks with the lowest risk produced the highest returns."

"Last month's residual return and the return over the preceding three months [positive price momentum] have negative predictive power relative to next month's return [are more likely to lose you money]."

"Four measures of cheapness; cash flow-to-price, earnings-to-price, book-to-price, and sales-to-price, all have positive payoffs."

The results were powerful. Value beat growth in every one of the forty-five years studied except one, 2003. Every value metric was found to be positively correlated to better future returns, and every measurement of momentum was found to be negatively correlated to future returns. Parallel studies have shown value beat growth in England, France, Germany, and Japan too. The results are overwhelmingly in favor of value investing and the effect isn't getting any weaker over time.

Chasing yesterday's winners or today's hot stocks is a recipe for disaster. Boring is beautiful. Out of favor is heavenly. The prudent investors shop from the stocks on the new lows list, not the new highs list. Buying value and going against the crowd is not only safer, it's more profitable. Slow and steady wins the day. Markets tend to overreact to news, creating buy opportunities and chances to sell at elevated prices.

WHY VALUE WORKS

Why is this true? It's certainly counterintuitive. How can a stock that just dropped thirty percent be safer than a stock that doubled in the past quarter? Why can you expect to make more money on a portfolio of big old boring blue chip stocks than small cap wonders?

The rationale for all this is as follows. Start off with the fact that we have a biological instinct to chase what is running and overlook what's familiar and barely moving. Worse yet, we are programmed to project trends, expecting that what has just happened will continue. Enter the charlatans, cowards and fools, willing to tell investors any story for their own profit, or are afraid to disappoint their clients or fail to understand the market. The result is a market that under-prices value and overprices growth.

Then we accentuate that mispricing by having talking knuckleheads in the media who are trying to make news. News is that some little biotech company has a new cancer drug. News isn't that Procter and Gamble gained 2% market share in the diaper market, but P&G will bring a lot more money to the bottom line {sorry about that} than that little biotech will. Finally, we have the quantitative traders and chartists who make their decisions based solely on price movement of the stock, accentuating what would otherwise be a minor trend, if it wasn't for their piling on.

For years now we have been reporting on the dismal performance of stock analysts. Study after study, in good and bad markets, showed their sell recommendations outperformed their buy recommendations. That's right, not just that their buy recommendations didn't do much better than the market, but that the few stocks that they had the courage to rate sells, did better than their buy recommendations. According to the latest figures reported by Bloomberg, analysts are getting even dumber. "Large company analysts failed to add value throughout the bull market that began March 2009. Through Dec. 31, the most-favored S&P 500 stocks posted average gains of 73%, compared to 165% for their least favorite."

The stocks they hated did twice as well as the stocks they loved! These people get paid for that? Unfortunately, this is entirely consistent with our contrarian thesis. Cheap stocks do better than expensive ones. Stocks don't get cheap because everybody loves them. Analysts provide a vital function for us. They encourage the crowd to act irrationally and create value.

The result is mispriced securities. It leads to companies that are temporarily selling below their intrinsic value and other stocks that make no investment sense. These abnormalities are usually corrected before long. Even more appealing are great companies that have long histories of steady earnings and dividend growth, who fly below investor's radar because the market rewards volatility more than consistency.

In our portfolios, we try to use a blend of stocks that have recently fallen from favor and stocks that tend to consistently offer superior value. The mix of fallen angels and orphans is to some extent dictated by market conditions. During major market corrections there are bargains galore, and even the fastest growing companies can be bought cheaply. Some of our best relative performance has happened after major market corrections as the fallen angels get their wings back.

As market recoveries become mature, the trick for us is to move from distressed securities to boring stocks that offer steadier, but less spectacular, appreciation potential. In the later stages of a bull market, we tend to underperform the averages because we are moving to less volatile securities, but if we do our job well, that temporary underperformance will be offset by downside protection when the market finally corrects.

We never get the timing quite right, but fortunately it doesn't matter. As long as we can buy a little when the market is having a panic attack, and avoid the most dangerous securities when the market is in mania territory, we will do just fine. We won't beat the market every year, but over time we should be able to offer our clients good investment performance based on a consistent philosophy.

Bill Matthes