



Investment Perspective

U.S. Core Equity



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A Return to Bellbottom Blues (and Trendless Markets)?

Finding an investment groove may be tougher in coming years

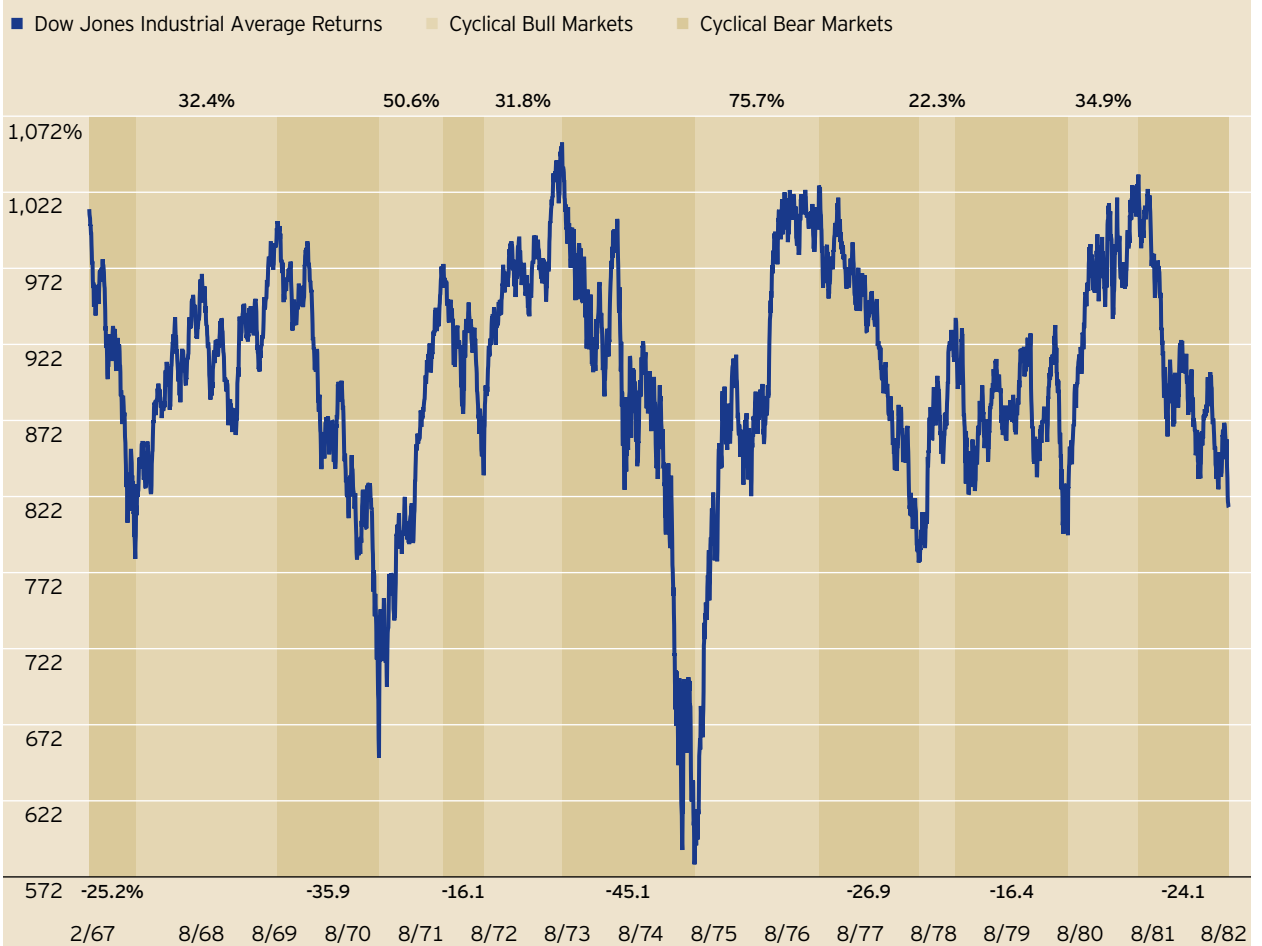
It may not necessarily be time to dig out the eight tracks and leisure suits from the attic, but the end of the extended secular bull market of the '80s, '90s and mid-2000s is likely giving way to an environment reminiscent of 1970s-style equity markets – trendless and volatile. While there are certainly differences between today's high-tech markets and that largely industrial era, there are also important similarities for investors to consider, especially equity valuations. More importantly, the opportunity and responsibility for fundamental active managers to add value is greater than it has been in decades.

Against the wind – going nowhere fast

As the grayer and more “seasoned” of us recall from the '70s, market behavior was characterized by frequent bull and bear cycles that culminated in equity indexes finishing a 16-year period right where they started (while losing out substantially in real terms against inflation). It was a go-nowhere, trendless era that frustrated broad equity market investors.

Figure 1: 1966 to 1982 - Volatile and Trendless

Cyclical bull and bear markets within a secular bear market from Feb. 9, 1966, to Aug. 12, 1982



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Contrast that period with the secular bull market that followed, where stock indexes averaged nearly 20% per annum between 1982 and 1999.¹ The '80s, '90s and mid-2000s enjoyed declining interest rates, low/stable inflation, strong – albeit leverage-driven – gross domestic product (GDP) growth and moderate taxation. This combination of favorable macro factors created a constructive economic backdrop and a structural increase in multiples versus historical norms.

We believe that markets have entered a period where some or all of those trends have reversed. For investors, this transition has important potential consequences. In this kind of environment, much like the period from 1966 to 1982, certain types of investment styles will be challenged. Yet, for traditional fundamental active managers, the opportunity and responsibility to add value is greater now than it has been in decades.

What implications does that reversal have for investors? To answer this question, we look at the surprisingly rapid transformation that has occurred in the economic landscape:

- A weakened, debt-laden consumer
- A debt-constrained U.S. government
- A weakened central bank (U.S. Federal Reserve [Fed])

The long-term consequences of these three realities are likely to be headwinds for GDP growth – and thus earnings multiples in equity markets.

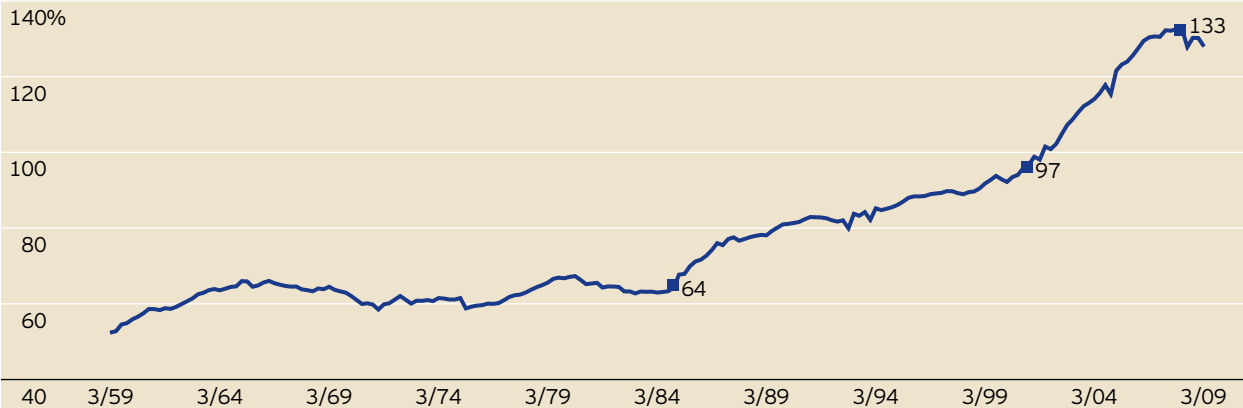
¹ Source: CrestmontResearch.com, Crestmont Research, © 2003-2009

Instant karma – the overextended consumer retrenches

From the early '60s up until the mid-1980s, the ratio of household debt to disposable personal income hovered between 55% and 65%.¹ Conservative attitudes toward debt still resonated with many consumers, as well as lenders, who had lived through the Great Depression and World War II. Starting in the mid-1980s, however, as interest rates headed lower, the ratio of household debt to income began to climb. By the end of the dot-com bubble in 2001, the ratio reached 96%, a 33-percentage-point increase in 16 years.¹ Although this was a big increase, it pales in comparison with the seven years from 2001 to 2008 when the ratio increased by 36 percentage points, up to 132%.¹

Figure 2: Household Debt Financed a Strong Consumer

U.S. household debt versus disposable personal income ratio since 1959



Sources: U.S. Federal Reserve, Bureau of Economic Analysis and Bloomberg L.P.

The magnitude of these debt levels isn't sustainable because the decline in assets (home values and investments) has altered the solvency of personal balance sheets. Paying down debt – or deleveraging – doesn't have to undermine the consumer, but it will likely serve as a headwind to consumption growth. To feel confident that we will see a sustainable recovery in consumer spending, we want to see improvement in the consumer balance sheet, a healthier housing market and a better outlook for jobs and income. Stimulus spending, tax refunds or lower gasoline prices, however, are unlikely to provide more than a temporary boost, akin to a sugar high.

Housing is the consumer's single biggest asset, and movements in home prices have a high correlation with consumer spending. The outlook here is mixed. On one hand, home prices in many regions of the country are down 40% to 50% from the peak, and the Case-Shiller national home price index has dropped 32% since mid-2006.² Such a large price drop suggests that we have already made it through the worst part of the housing correction, which is a positive for the consumer.

We worry, though, that a longer term "jobless recovery" will impede a return to strong wage and income growth. Each of the last three economic upswings has been accompanied by successively weaker recoveries in the job market, and we see little reason why this cycle would be different. While job losses and the unemployment rate are lagging indicators in terms of predicting a recovery in the economy, we would hope to see a better long-term employment outlook to become more positive on consumer spending.

1 Sources: U.S. Federal Reserve, Bureau of Economic Analysis and Bloomberg L.P.

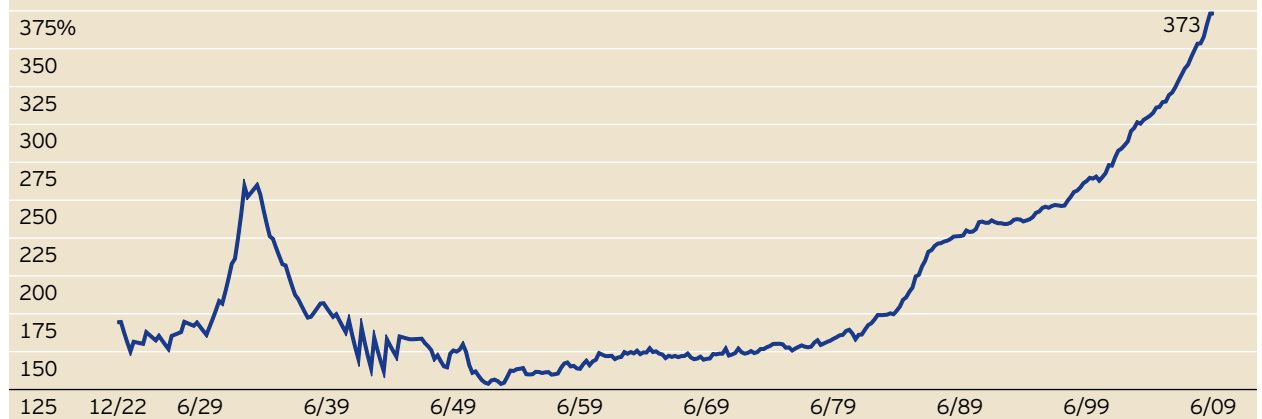
2 Sources: Standard & Poor's/Case-Shiller, Bureau of Labor Statistics, Bloomberg L.P.

Fear the reaper – mounting U.S. debts do matter

Debt levels ballooned in the '80s – from the first quarter of 1981 through the fourth quarter of 1993, total credit market debt surged from \$4.8 trillion to \$16.0 trillion.¹ Even when viewed as a percentage of the U.S. economy, debt levels surged from 162.4% to 247.3% during the period.¹ Today, total debt has reached \$53 trillion, and we have been borrowing from the future to pay for today for 25 years.¹ This leverage has been a significant force behind GDP growth that has likely reached a saturation point.

Figure 3: Total Debt as a Percentage of GDP

U.S. debt levels have grown substantially from 1922 to 2009



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High debt levels also have another side effect: disinflation. Because consumers and businesses have limited spending, they must retrench once they reach their saturation points. Deleveraging thus will be a headwind to GDP, to an unknown degree.

Historically, there has been a pretty clear inverse relationship between interest rates and market multiples. During periods of declining interest rates, investors are willing to place a large valuation premium on future earnings, and vice versa.

The problem with large deficits is that over time, they weaken the Fed's ability to guide the U.S. economy. This occurs when the private sector must raise interest rates to compete with the financing needed by the public sector (the "crowding out" effect). Higher interest rates eventually slow economic growth, at which point the Fed must act with greater authority to direct larger amounts of borrowed capital. This leverage most likely increases economic risk by making the economy more volatile and more vulnerable to outside shocks.

Running on empty – staving off depression leaves a weakened Fed

Over the past 30 years, the Fed's role has changed from an entity that seeks currency stability by managing the money supply to meet the needs of the economy to an institution that tries to manage the economy itself and avoid recessions at all costs. It has succeeded in minimizing the depth and duration of recessions, but it has incurred costs, albeit delayed costs.

The Fed's primary tool for influencing the economy is spread management – lowering short-term rates to stimulate economic growth and increasing rates to stem the threat of excessive inflation. Over the past several decades, the level of interest rates has been in a secular decline, with rates finally arriving at a target rate of 0% to 0.25% today.² This trend has now reached a natural floor at which the Fed can no longer lower interest rates to spur growth. The only direction for rates from here is either flat or higher, which is yet another headwind for equities.

1 Source: Copyright Ned Davis 2009 © Ned Davis Research Inc. All rights reserved.

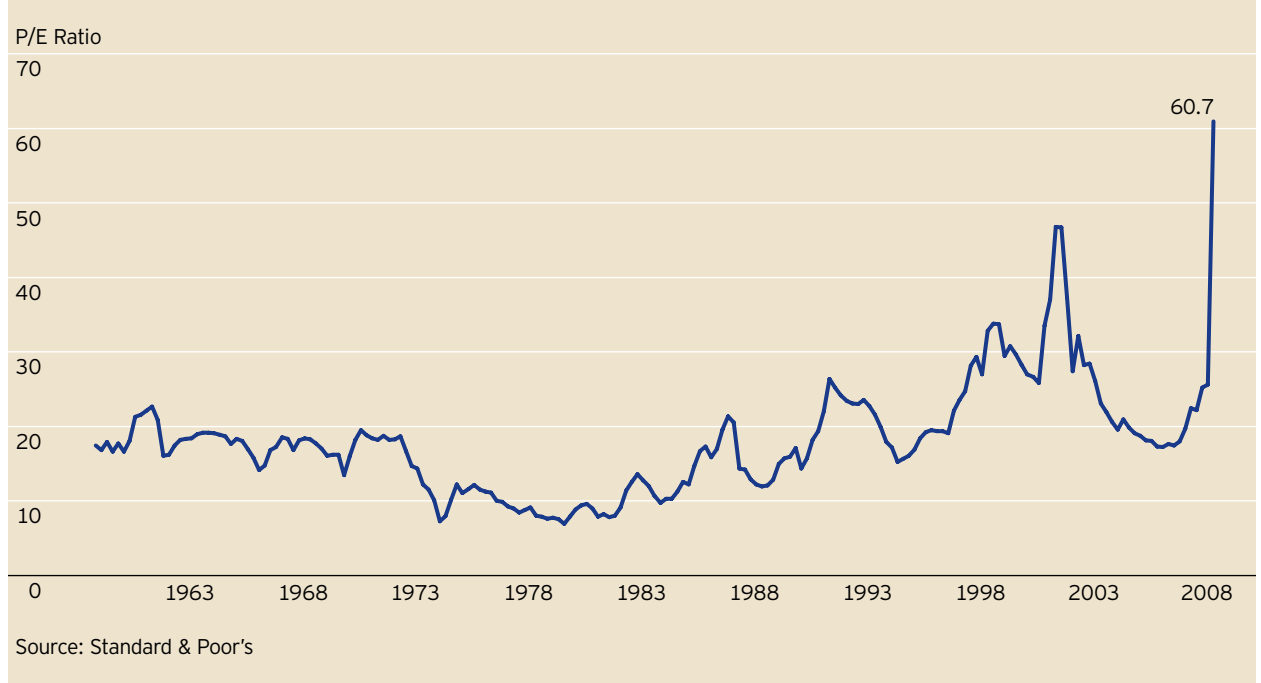
2 Source: bankrate.com, as of Nov. 24, 2009

Earnings multiples – meet the new boss (same as the old boss)

A return to prior peaks in earnings power is unlikely for the foreseeable future. The last cycle produced a huge bubble in financial, energy and materials profits that is unlikely to repeat. At the peak, these three sectors contributed 45% of total S&P 500 Index profits, relative to a long-term average in the low 30% range.¹ Financial firms have quickly reigned in leverage, which means earnings growth will most likely moderate. Energy and materials companies are battling with deflationary pressures, but this could quickly turn and serve as a tailwind for their earnings. We are less optimistic about their potential return to peak earnings, although this generally happens later in the market cycle. When the outsized contributions from these sectors are stripped away, earnings power for the S&P 500 Index over the near term looks significantly weaker.

Figure 4: A Return to 'Normalcy' for Earnings Multiples?

S&P 500 Index price-earnings (P/E) ratios based on long-term multiples earnings



Prior to 1982, the historical average P/E multiple for the S&P 500 Index was 13.2 times trailing 12 months earnings.¹ From 1982 to 2008, this multiple was 20.84, a huge structural increase driven by the secular catalysts we've outlined.¹ In the absence of these catalysts, we think a return to more normal valuations is a reasonable expectation. We don't think multiples will return to a long-term average of 13 times because our economy is more global and diversified in nature than in our more industrial years, so maybe something in between is reasonable, say around 15 times. The specific number is less important than the range.

Finally, in the absence of such strong secular catalysts, how should we expect the markets to behave going forward? We think 1966 to 1982 is a reasonable comparison. We may not exactly repeat this environment, but we think things will be more like this period than what we saw from 1982 to 2007. In the '70s, the market struggled for leadership. Performance was narrow, meaning it was often concentrated in certain sectors and companies as opposed to broad markets – where you have strong leadership widely dispersed across the markets. Going forward, we think investors should expect similar volatility and more frequent inflection points. Successful investing will require a more disciplined approach. The gap between "winners" and "losers" in stock picking is likely to be wider, as quality companies take advantage of weaknesses among vulnerable business models that flourished by virtue of all the favorable economic tailwinds.

This market environment will challenge momentum-orientated approaches that require directional stock price persistence for both fundamental and quantitative investment approaches. Interestingly, it could also challenge index funds, which would not fare well should major equity indexes flounder in a trendless market. Instead, we believe old-fashioned, fundamental research that focuses on quality stable growth companies will distinguish itself. Investors will need to be diligent about selling at conservative target prices, be patient with the cash proceeds and be opportunistic in exploiting market anomalies when they arise.

¹ Source: Standard & Poor's

We're sure there are plenty of investors who don't share our outlook on the markets; however, it is important to consider the consequences of being wrong. The risk of not planning for the possibility of trendless, volatile markets is much greater than the risk of planning for it and being wrong. If we are wrong and the market delivers a robust bull market over the next few years, then as equity investors we may benefit from those positive returns, but we will give up some upside in exchange for greater downside protection. We believe investment management is about risk management, and we prefer being judiciously conservative with our portfolio's positioning rather than speculative.

Conclusion

I've peppered this commentary with a few songs from the '70s, which might make you think I'm resigned to a market environment headed for malaise. Certainly, the current level of unemployment and prospects for GDP growth are cause for concern. But aside from nostalgia for the music of that decade, I am also optimistic from an investing perspective about a 1970s-type of trendless market. Unlike the secular bull market of the '80s and '90s, where market volatility and bubbles delivered the bulk of returns, a trendless market separates quality investors and quality research from luck on a larger scale. This kind of environment has very important implications for how investors construct their portfolios. We firmly believe experienced active management with a conservative core approach has the opportunity to add real value for clients.

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