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RESEARCH NOTES

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THE MADNESS OF CROWDS

"If you can keep your head when all about you are losing theirs…" - Rudyard Kipling

Although Kipling's most famous verse may seem too obvious in this context, we can't think of a better time to invoke it. As we go to press, the Dow is down another six percent today, adding more pain to the 22% decline already for the year. The advance/decline ratio is an unheard of 1:30, and the VIX (volatility index) is at a record 57. To call what we are witnessing today anything other than panic selling would be bordering on delusional.

In our September 16th communication we warned of further volatility to come, but had hoped that passage of the government "bailout" plan would bring some relief to the markets. The credit crisis, rooted in this country's highly-leveraged housing and financial sectors, now appears to be spreading across the globe, with ominous implications for the economy. These developments are disconcerting, and we do not take them lightly. On the other hand, the market action today is showing all the classic signs of "capitulation," the final stage of a bear market when investors simply sell, regardless of whatever intrinsic values their holdings may embody. As tempting as it may be to succumb to one's deepest fears about financial security when the media is feeding the anxiety, we continue to counsel patience and perspective. We certainly acknowledge the concern, but as professional advisors cannot ignore the potential for outstanding opportunity presented by the indiscriminate selling.

The stock market is often referred to as a "discounting mechanism." Stock prices are forward looking, in that they collectively embody expectations about the future, including some premium for perceived risk. In today's environment of ubiquitous communications and electronic trading, changing investor perceptions are reflected in the market instantly, contributing to volatility. While this may be unnerving for individual investors, it is important to understand the implications of this dynamic: new information – both bad *and good* – can change the direction of the market in an instant.

In recent months, we have seen a healthy repricing of risk across the investment landscape. The "risk premium" offered by stocks (the excess expected return over the risk free rate) is the most generous in at least fifteen years, perhaps more. We may be in a recession, and it may be a nasty one – but the deterioration in the market (some 35% since last November's peak) far exceeds the likely decline in the economy. At the beginning of this year, the twelve-month forward earnings estimate for the S&P 500 was $100.41. Today, with the current negative outlook factored in and *including* the horrendous losses in the largest component of the index, financials, the current twelve month forecast is $87.40 – a decline of only 13%!

In times like these, we find encouragement in the words and actions of many legendary investors. Although the current decline is increasingly being compared to 1929, Seth Glickenhaus, the 94 year-old founder of Glickenhaus & Co., noted the “conspicuous difference” between today and that dark period in history. Unlike the misguided contractionary policies of President Hoover and Treasury Secretary Mellon, “this time, the government is moving heaven and earth to reverse the cycle.”[1] Warren Buffett recently expressed his confidence in the market by taking sizeable new stakes in Goldman Sachs and General Electric. Renowned value investor, Columbia professor Bruce Greenwald, last week told an audience “There are no bad days in the market. When the market is down, you’ve got bargains, and it’s lovely to think of what you are buying at low prices. When the market is up, the bargains have gone, but you’re rich.”[2]

While we’re all feeling a lot less rich today, the principle holds true. If you are a net saver, this may be the best investment opportunity in a generation. If you are a retiree who depends on your investment portfolio for income, our focus on balance sheet strength, valuations, and cash flow should ensure a growing dividend stream.

Benjamin Graham famously observed, “In the short run, the market is a voting machine but in the long run it is a weighing machine.” Today, market participants are voting with their feet… but we are convinced that today’s prices bear little relation to the full weight of the quality earnings and dividend streams in our portfolios. In the meantime, as we have discussed, the outlook for future returns is improving by the day, and we are actively examining this reshaped landscape for the opportunities that are before us.

If you have questions or comments regarding this or any other Research Note, click here to contact the Research Department.

[1] Wall Street Journal
[2] Barron's