



Pessimism, Paranoia, and Probabilities

In our experience, we believe there are four basic types of investor personalities: Risk-Seekers, Realists, Pessimists, and Paranoids. Members of the first group actively take on large amounts of risk with their investments, either to pursue outside gains or to satisfy an internal appetite for speculation (or both). Realists try to calibrate the amount of risk they take in their investment portfolios to fit a rational risk/reward profile. Pessimists tend to view the market's "cup" as half-empty, so they design their investment portfolios to minimize risks, while allowing for some small amount of potential reward. Paranoids are unwilling to even consider the possibility of reward in their investment portfolios, because they are completely consumed with eliminating all sources of risk.

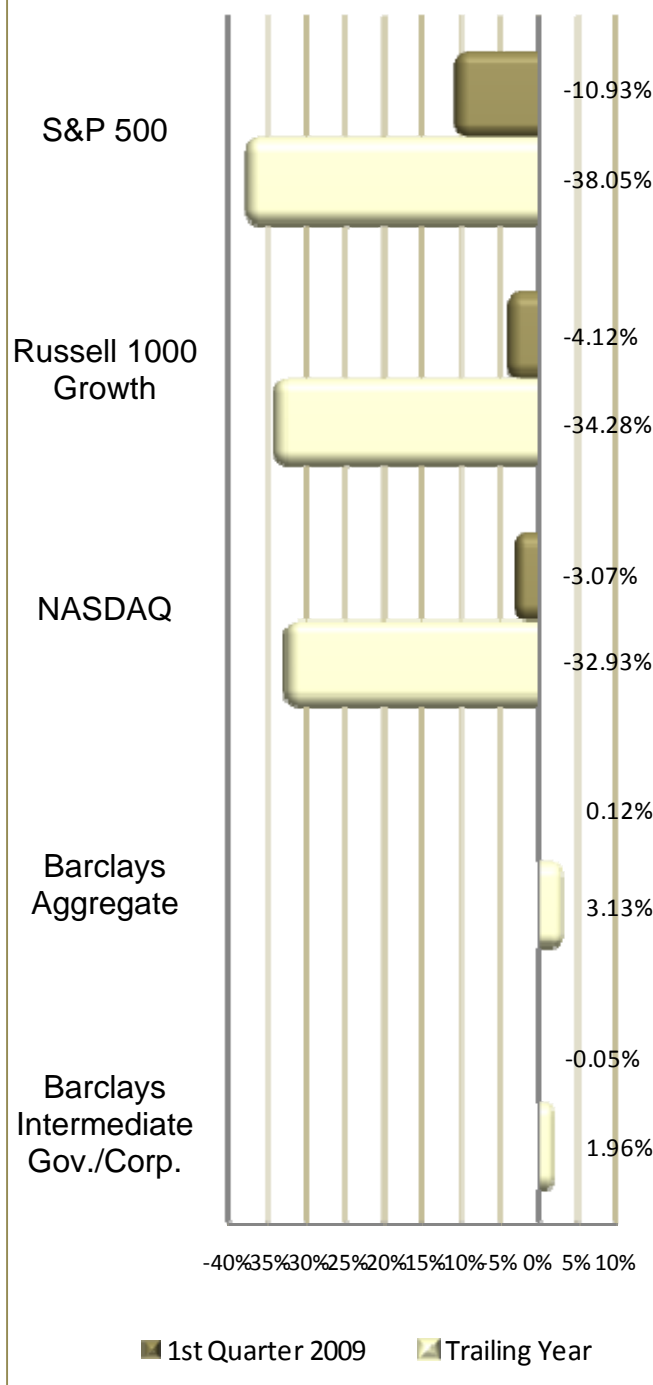
As February 2009 passed into history, overall investor sentiment had progressed from historically negative extremes of pessimism into something resembling out-and-out paranoia. As noted above, people who are *paranoid* imagine that the worst case scenario must *always* come to fruition (see the cartoon above). When we say that overall investor sentiment approached paranoia in February, we mean that many investors had become "convinced" that equities were, by definition, vehicles for incessant wealth destruction.

In practice, paranoid investors often let unbridled fear drive them to extremes of action, including liquidating their portfolios en masse during periods of market stress, without regard to their long-term plans or probabilities of return. Mutual fund data from The Investment Company Institute (ICI) are supportive of the prevalence of paranoia in recent months. ICI data show that investors liquidated over \$125 billion of net equity fund holdings between 9/30/08 and 2/28/09, representing a massive stampede for the sidelines among individual investors. Again, in our opinion, this was reflective of paranoia, not mere pessimism.

The market's scorecard in early 2009 reinforced a widespread sense of gloom and hopelessness. As of the end of February, the S&P 500 had declined in five out of the most recent six months, leaving the index lower by 18% for the year and 52% below its October 2007 high.

(continued on the reverse)

Market Index Update



-40% 35% 30% 25% 20% 15% 10% 5% 0% 5% 10%

■ 1st Quarter 2009 ■ Trailing Year

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Pessimism, Paranoia, and Probabilities (continued)

The mood got increasingly gloomy through March 6, when the S&P hit an intraday low of 666, representing a 13-year (!) low for stocks.

And then, very suddenly, when almost everyone least expected it, the market reversed direction and headed north. Buyers stepped in, sellers retreated, and the stock prices posted a rally of historic proportions. **For the 19 trading days following the March 6 low through April 3, the S&P 500 rose by 24.5%, representing the index's biggest 19-day rally since 1932.**

Some market commentators are deriding the March 2009 super-rally as a "dead cat bounce," or a "bear market rally" that predestines a near-term return to the lows. While we do not know with any certainty which direction stocks will go in the coming few months, we do think that the March 2009 low of 666 for the S&P 500 could prove to be a long-term low for U.S. equities. For historical perspective, we think we are living through an important inflection point for equities—similar to periods such as 2002-2003, 1981-1982, 1974-1975, and 1937-1938. These sorts of periods, like today, were characterized with terrible economic news, widespread revulsion for stocks, increased government regulations, and geopolitical instability. The headlines during each of these important market bottoms were exceedingly negative, and yet equities stubbornly insisted on gradually working higher over the subsequent months and years.

While it is obviously *possible* that the S&P 500 will go meaningfully lower from current levels in the low 800's, we believe the probabilities are heavily in favor of strongly positive returns for equities in the coming few years. We base that assertion upon our assessment of investor sentiment, economic fundamentals, and stock valuations:

- **Investor sentiment**

As we have detailed, investor sentiment has verged on paranoia for months. Mutual fund outflows, a variety of investor surveys, our own clients' comments, popular media outlets, and industry publications all bear out the point that investors have lost most or all of their faith in wealth-building power of the stock market. It is vital to note that every long-term low in the history of stock market has been accompanied by horrible investor sentiment.

- **Economic fundamentals**

The U.S. economy officially entered recession in December 2007, meaning that we are currently in the 16th month of the current economic downturn. This will no doubt be the longest recession since World War II, and it could potentially be the deepest post-war recession as well (depending upon the ultimate levels of unemployment and Gross Domestic Product). As consumers and corporations adjust to the slowing economy, consumers are spending less and companies are suffering earnings declines. GDP declined 6.2% in the 4th quarter of 2008, and expectations are for another decline of between 1% and 2% in the first quarter of 2009. Adjusted S&P 500 earnings are projected to be \$68.64 in 2009 and \$62.53 in 2010, down 22% and 29% respectively from the high of \$88.17 in 2006. All of this is short-term bad news, but there are tentative signs of a bottom in prices for residential real estate, crude oil, copper, base metals, agricultural products, and stocks. Several leading economic indicators are ticking upward, leaving open the possibility that the economy could bottom as soon as the second half of 2009.

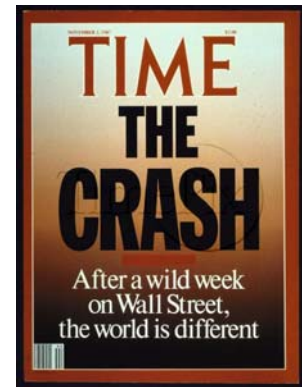
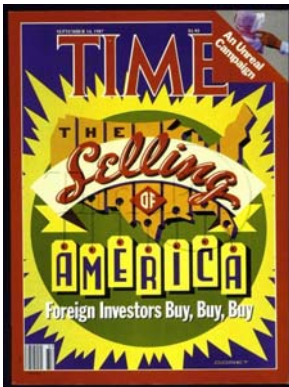
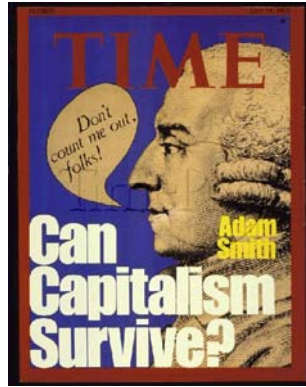
- **Valuations**

At current levels (roughly 825 on the S&P 500 at time of writing), U.S. blue-chip stocks trade at 13 times estimated 2009 adjusted earnings per share. Given a long-term average multiple in the mid-teens, we can infer that stocks are reasonably inexpensive by this measure—but not screamingly "cheap." However, we believe a better measure of valuation may be a comparison of current stock valuations to the "peak" earnings that are likely to be achieved when the economy recovers. In hindsight, we at JAG believe that the 2006 peak adjusted earnings of \$88.17 were at least partially inflated by excess leverage in the financial sector, so we apply a discount to previous peak earnings to come up with a prospective future peak earnings figure of \$80 per share for the S&P 500. By that methodology, the S&P 500 is trading at roughly 10 times our adjusted peak "leverage adjusted" earnings, implying that U.S. blue-chips could be unabashedly undervalued at current levels. This is especially true when we consider risk-free U.S. Treasury bond yields. Consider that, at time of writing, the 10-year U.S. Treasuries yield 2.75%. Stated another way, the U.S. Treasury trades at 36 times earnings (!). Which asset is a more attractive investment? Blue chip U.S. stocks at 10 times peak earnings, or U.S. Treasury obligations at almost 40 times earnings? We think the answer is clearly in favor of equities, particularly for investors who have at least a 3- to 5-year investment horizon.

Of course, the road ahead is not a clear path to prosperity. We are suffering the after-effects of too much leverage in the global economy. One way or another, excess debt at the consumer, government, and corporate levels will need to be worked off in the coming years. The massive intervention of the U.S. government into the private affairs of financial institutions and automakers will no doubt have a variety of unintended consequences. Geopolitical instability, which has been ebbing and flowing for over 60 years, is again a rising risk to the outlook for the world economy. And finally, the massive increase in the size of the U.S. government balance sheet will likely lead to much higher inflation, and potentially much higher interest rates, within the next decade. But we believe that these headwinds have been largely accounted for in recent asset prices. If we are correct, early 2009 could mark an important low for U.S. equities, with important implications for the future of astute and patient investors.

The More Things Change...The More They Stay the Same

Snapshots from the 1970's and 1980's demonstrate "the good old days" were also marked by pessimism and paranoia.



This passage may seem as if it was written yesterday...

- “ ... the nation is now also plunging deeper into a recession that seems sure to be the longest and could be the most severe since World War II. Consumers who a few [months] ago worried mostly about rising prices now fear for their jobs and incomes as well.”
- “ All last week the bad news mounted. The auto industry reeled from a new-model sales rate 35.8% below last November's already somewhat depressed pace. Ford and Chrysler announced massive new layoffs for this month. Automakers now plan to close at least 14 assembly plants and put as many as 230,000 production workers, clerks, accountants and executives out of work.”
- “ But the decline is no longer confined to autos and home building, which is down 33% from [last year], as it has been for most of this year. In classic fashion, the recession has begun to work its way through the entire economy. Although demand for home freezers is still high, with housewives stocking up on food to beat rising prices, sales of other major appliances—TV sets, washing machines, dryers, vacuum cleaners—are turning sick, and layoffs are spreading in the plants that make them.”

- Time Magazine, December 9, 1974

...but it actually appeared in Time Magazine almost 35 years ago!