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Investment Strategy

"Compelling Valuation, or Value Trap?"

> "Valuations for U.S. equities have been stuck below the five-decade average for the longest period since Richard Nixon's presidency; a sign investors don't trust earnings even after a three-year bull market. Analysts estimate profits in the Standard & Poor's 500 Index will reach a record $104.78 this year after increasing 125 percent since the end of 2009, the fastest expansion in a quarter century, according to data compiled by Bloomberg. American companies are boosting income so much that even after stocks doubled, the S&P 500 hasn't traded above its 16.4 mean ratio for 446 days, the longest stretch since the 13 years beginning in 1973."
>
> . . . Bloomberg 1/30/12

I was interviewed for the aforementioned article, and while those comments were not used, my response to the reporters' questions were pretty much along the same lines as the pundits' words included in said quip. To be sure, investors have been freaked by the 11.9% decline in the S&P 500 (SPX/1344.90) since 2000 (aka, the lost decade), the 2000 – 2002 Tech Tragedy, the 2008 Financial Fiasco, Euroquake, the Flash Crash, Flash Trading in general, Dark Pools, Huddles, etc. The result has left the average investor with the feeling the game is rigged and the "little guy" doesn't have a chance. Hence, they don't participate, leading to the longest stretch where the SPX has not traded above its mean 16.4x P/E ratio in decades. Yet the real reason for investors' fears is that they did not manage the risk when they should have.

Indeed, the reason for investors' "stock shunning" is simple . . . most do not adhere to the main tenant proffered in Benjamin Graham's book "The Intelligent Investor." To wit, "The essence of portfolio management is the management of **risks,** not the management of **returns**." Or as my father says, "If you manage the downside the upside will take care of itself; avoid the big loss." "The management of risk," what a novel concept, yet it is unpracticed by many investors. Case in point, in March and April of last year my "call" was to raise some cash by selling partial long stock positions, allowing long-term capital gains to accrue to portfolios. The majority of responses I received to that strategy were, "Hey Jeff, the stock market is going up, why should I sell some of my stocks?" The reality is, that was precisely why you should have rebalanced some of your stock positions that had grown into too big a portfolio "bet" because they had rallied so much. But instead, what happened? Most participants failed to heed that advice and thus suffered through a 19.6% decline in the SPX between May and August. Regrettably, because they didn't manage the risk, they panicked at the August "lows" and sold when we were actually recommending recommitting capital to equities.

What inevitably happens when a portfolio begins to erode, investors are told, "No one can time the market; and that it is time in the market not timing the market." Or, "If you miss the 10 best days in the market your total return falls significantly." Of course, investors are never told that if you miss the 10 worst days your returns swamp the return of investors who stayed the course and rode the "ups," as well as the "downs." Now I admit, n-o-b-o-d-y can consistently "time" the market on a weekly or a daily basis; yet, there are numerous indicators that tell us when we should be aggressive, and when we should be defensive. Moreover, you can pretty much count on me to sell 25% – 33% of any portfolio position if it is up 100% to rebalance that position; and, I don't care if the gain is long-term or not. You can also count on me to take some kind of defensive action (sell, hedge, etc.) when something goes against me between 15% – 20%. Indeed, avoid the big loss.

Circling back as to why the SPX has remained below its median P/E multiple for the longest time in decades, in my opinion it's because participants failed to manage the risk at the upside inflection points, putting themselves in a position of panic at the downside inflection points. So once again I will say it, the stock market is fear, hope, and greed only loosely connected to the business cycle – manage the risk! So where does all of this leave us? Well, I have been consistent in the belief there is going to be no double-dip recession, unless we talk ourselves into one, and the strengthening economic data reinforces that view. If correct, the SPX should earn somewhere between $100 and $110 in 2012. At 1344.90, the SPX is trading in the range of a 12.2x to 13.5x this year's estimated earnings. The question then becomes, given the news backdrop what is the appropriate P/E level for those earnings? Using Bloomberg's 16.4x median P/E multiple seems a bit too optimistic to me, yet even haircutting that P/E ratio to 14.5x earnings still gives investors plenty of room on the upside, provided they manage the risk.

Speaking of managing the risk, after being extremely bullish at the August 2011 "lows," and wildly bullish at the October 4, 2011 "undercut" low (consistent with my 1978 and 1979 trading pattern analogies), I stayed positive on stocks into year-end, as well as

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into the new year. That said, I turned more cautious a few weeks ago because stocks had become very overbought (read: too much bullishness) in the short term, and most of the market's internal energy had been used up in the upside dash from the October "lows" into the recent mid-January "high." The only question I posed was, "Is this going to be a sideways correction, or are we going to get more of a pullback?" Whatever the pattern, I continued to suggest it would be a mistake to get too bearish. So far, it has been pretty much a sideways affair with the SPX only 17 points above where it was when the Buying Stampede ended on January 25th. Still, the SPX is two standard deviations above its 50-day moving average and consequently very overbought (again). Likewise, the McClellan Oscillator is back into overbought territory, many of the indices I follow are up against their respective downtrend lines, as seen by connecting their May 2011 highs with their July highs, none of my short-term indicators are bullish, near-term performance following upside "gaps" like last Friday's typically has been poor, and there is the potential for a double-top in the DJIA (INDU/12862.23), which would be negated with a close above 13250. On the positive side are the fundamentals, various Dow Theory "buy signals," huge sideline cash (read: the underinvested crowd), last night's win by the New York Giants (Super Bowl Indicator), and the stock market's internal energy is quietly being rebuilt.

Given the short-term "mixed metaphors," while I still think it is a mistake to get too bearish, I also remain timid on a trading basis. So what are participants to do? Well, one tack to take is accumulating good companies with solid fundamentals and the potential of being acquired. Names mentioned over the past few months by our fundamental analysts that fit these criteria include: Anadarko Petroleum (APC/$84.34/Strong Buy); Big Lots (BIG/$43.59/Strong Buy); Casella Waste (CWST/$7.00/Strong Buy); Interactive Intelligence Group (ININ/$27.78/Outperform); Kodiak Oil & Gas (KOG/$8.66/Outperform); Lumos Networks (LMOS/$16.23/Strong Buy); National Penn Bancshares (NPBC/$9.74/Strong Buy); and Oasis Petroleum (OAS/$31.91/Outperform). We have "sound bites" from our analysts on all of these companies underscoring the basis for our positive rating, and in many cases why the analyst believes the company is a potential acquiree; please see our recent fundamental research on these names.

The call for this week: Remember all those Negative Nabobs that caused you to panic and sell-out at the August lows? Or, the Bear Boos who told you the undercut low of October 4, 2011 was the start of a whole new leg to the downside? Then there was the Cowering Crowd that insisted the first half of 2012 was going to be terrible. Such rants have left the world profoundly underinvested in U.S. equities. So when you are thinking of getting really bearish, study the attendant chart from our friends at Riverfront, and sourced to Intrinsic Research, which shows revenues, earnings, and the SPX's share price for the past decade (through 12/8/11). Revenues and earnings are at all-time highs, yet the SPX is ~13.5% below its October 2007 "high;" indeed, "Strange brew trying to get through to you…" (Cream 1967; Eric Clapton at his finest).

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Chart 3: S&P 500 (Ex-Financial): RPS, EPS and Price

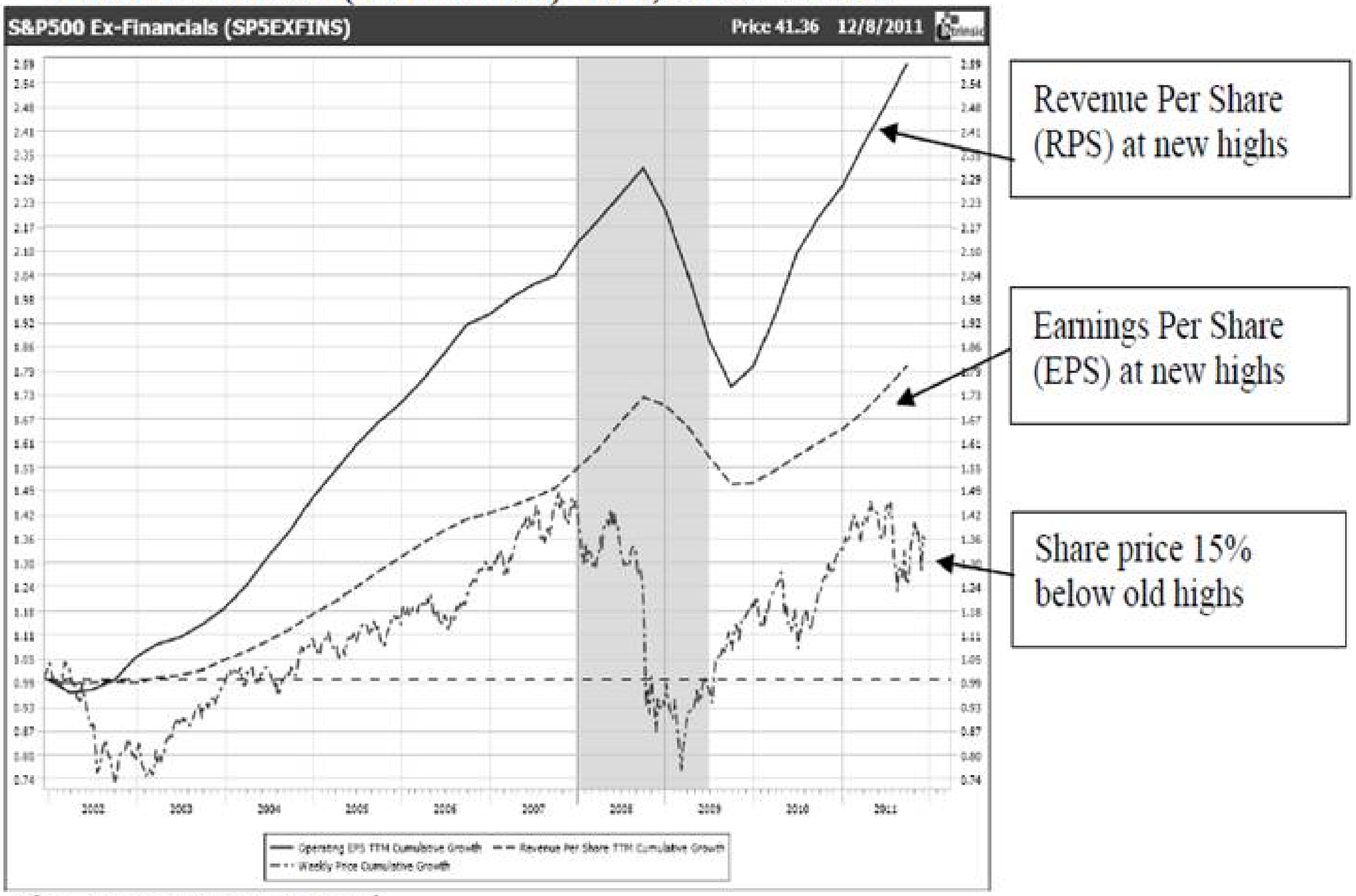

Chart Courtesy Intrinsic Research

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