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Investment Strategy

Zebras!?

> "Zebras have the same problem as institutional portfolio managers. First, both seek profits. For portfolio managers, above average performance; for zebras, fresh grass. Secondly, both dislike risk. Portfolio managers can get fired; zebras can get eaten by lions. Third, both move in herds. They look alike, think alike and stick close together.
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> If you are a zebra, and live in a herd, the key decision you have to make is where to stand in relation to the rest of the herd. When you think that conditions are safe, the outside of the herd is the best, for there the grass is fresh, while the middle see only grass which is half-eaten or trampled down. The aggressive zebras, on the outside of the herd, eat much better. On the other hand – or other hoof – there comes a time when lions approach. The outside zebras end up as lion lunch, and the skinny zebras in the middle of the pack may eat less well but they are still alive."
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> . . . Acorn Fund's founder, and portfolio manager, Ralph Wanger

We saw many "outside zebras" gorging themselves on stocks in late 2007 as the D-J Industrial Average (DJIA/9665.19) registered a new all-time high in October of that year (at 14164). Those outside zebras ended up as "lion lunch" when the senior index shed an eye-popping 53% over the ensuing 17 months. By then many of those outside zebras had moved to the inside of the herd just in time to miss the March 2009 bottom (at 6627). Since those lows, more and more zebras have ventured back toward the "outside" of the herd driven by performance pressures. We have repeatedly commented that given the immense amount of cash still on the sidelines, as the equity markets continue to rally the performance pressure, subsequent bonus pressures, and ultimately job pressure, become just too great, causing portfolio managers to "pay up" for stocks. And that, ladies and gentlemen, is why the corrections have been short and shallow since the anticipated March "lows." As the sagacious Jeremy Grantham writes:

> "In markets, where investors hand over their money to professionals, the major inefficiency becomes *career risk*. Everyone's ultimate job description becomes 'keep your job.' Career risk-reduction takes precedence over maximizing the client's (portfolio) return. Efficient career-risk management means never being wrong on your own; so herding, perhaps for different reasons, also characterizes professional investing. Herding produces momentum in prices, pushing them further away from their fair value as people buy because others are buying."

Clearly, this "performance pressure" is currently playing on the "street of dreams" as the DJIA tagged another new reaction "high" last Wednesday at 9918. Since then, however, it has surrendered roughly 277 points, causing one market maven to ask, "What sparked the late week wilt; and, is this finally the beginning of a decent correction?"

Speaking to the first question, our guess is the "stock sag" was sparked by last Wednesday's FOMC policy statement. As our economist, Dr. Scott Brown, wrote:

"As many had speculated, the FOMC also decided to slow the pace of its purchases of agency debt and mortgage-backed securities, tapering them off by the end of 1Q10. This is meant to provide a smooth transition in the markets (similar to the exit plan for the plan to purchase long-term Treasury securities)."

To us that statement isn't particularly pleasant reading; and then there was this from Fed Governor Kevin Warsh:

"And our policy judgments will ultimately prove worthy of the accolades, and tender the ultimate rejoinder to our critics, if we rise to meet this heightened responsibility. I am confident we will. . . . That outcome will require that policy makers have equal parts capability, clairvoyance and courage – perhaps the most important of which is courage."

Let me interpret Mr. Warsh's verbiage – don't let this stock market "melt up" turn into yet another mania/bubble or we will take dramatic action (can you spell irrational exuberance?). Add to that verbal backdrop August's first slide in existing home sales since March, and a less than stellar durable-goods report, and was it any wonder stocks stutter-stepped late week?

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Speaking to question number two, October isn't a four-letter word, but it should be . . . especially with the month's hysterical history. For instance, the 1987 "crash" (stocks down 22.6%), the great crash of 1929 (down 12.8%), October 1937, October 1932, the back-to-back "massacres" in 1978 and 1979 . . . well you get the idea. Nevertheless, we still can't shake the feeling that any stock correction will be shallow and short for the aforementioned reasons. As well, we continue to think earnings comparisons should look pretty spiffy year-over-year; and, the Economic Cycles Research Institute's (ECRI) Weekly Leading Economic Indicator Index continues to probe generational "highs." All of this "foots" with our sense that the economic recovery is going to be stronger than most expect, a gleaning reinforced by the surging steel stocks.

That said, we too worried in last Tuesday's strategy comments that said "melt up" might be creating an upside vacuum, which may get "filled" on the downside once quarter-end "window dressing" is over. Accordingly, our "buy" recommendations on the indices of July 14, 2009, was "stopped out" (read: sold) when they broke below their respective 10-day moving averages (DMA) last week. As well, our long-standing recommendation on platinum was "stopped out" when it too traveled below its 10-DMA. As for our sense that the "leaders" in the new global bull market are the emerging markets, it is worth mentioning that after underperforming the world markets in 2008, emerging markets have strongly outperformed in 2009 and now represent more than 12% of the world's equity market capitalization. We have long suggested that this would be the case and continue to believe so. In addition to the various exchange-traded funds (ETFs), closed-end funds, and open-end mutual funds so often mentioned in these missives, like MFS's International Diversification Fund (MDIDX/$11.72), we continue to think a portion of your portfolio should be directed toward emerging and frontier markets.

Indeed, emerging markets have better demographics, better productivity growth, lower debt, and rising demographic trends that should spur pent-up demand in consumer and infrastructure growth. Manifestly, emerging and frontier markets have better growth prospects than most of the developed countries. Therefore, we are buyers of emerging and frontier markets on pullbacks, just like we have been buyers on declines in the U.S. equity markets. That strategy is driven by our belief that at the March 2009 "lows" the equity markets were three to four standard deviations below "normalized valuations." Subsequently, they have rallied back only to the "norms." Given the generational "oversold" readings at those March "lows," there is no reason the equity markets cannot achieve one to two standard deviations above normal valuations. That implies a price target of over 1200 on the S&P 500 (SPX/1044.38). Accordingly, we remain bullish on a longer-term basis, despite our near-term cautious stance as we enter 4Q09.

The call for this week: Despite last week's 2.24% slide in the S&P 500, all that has really happened is that most of the indices we follow have merely pulled back to support levels. Moreover, the breadth (Advance/Decline Line) has remained strong and some of the overbought condition has been worked off (78.2% of SPX stocks are above their respective 50-DMAs, down from 92.4% on September 18th). Meanwhile, all 10 of the S&P macro sectors were lower on the week. However, parsing the S&P's subsectors shows that Specialty Chemicals, Autos, Distillers & Vintners, Nondurable Household Products, Travel & Tourism, and Biotech were the only positive weekly subsectors. Interestingly, Natural Gas prices (Henry Hub) leaped 13.92% week/week; and don't look now, but this week's *Barron's* carries an article that reads, "Property-and-casualty (P&C) insurers are among the safest financial-service plays, but investors have shunned them this year. That's a mistake." We agree and would note that there have been NO hurricanes in the Gulf of Mexico this summer, implying that P&C companies' third quarter earnings ought to make for pleasant reading. From our universe of stocks, 2.7%-yielding Allstate (ALL/$29.13/Strong Buy) and 2.95%-yielding Chubb (CB/$48.82/Outperform) appear attractive.

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