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January 18, 2011
Investment Strategy

How High is High? (To Whom?)

> *I have a number of friends who succeeded as investors in the late 1960's, and they are succeeding now. The key to their success more than 20 years ago was that they managed to get out with most of their capital when the market turned down. Most investors were not so astute. The name of the game most investors play is momentum and relative strength: Buy the strongest stocks and sell them after they have topped. Occasionally I will ask of my friends, "How can a rational person pay 60 times earnings and 10 times book value for a growth company with dubious long-term prospects?" The reply: "How high is high? If a stock can sell at 60 times earnings, it can sell at 80 times or 100 times. I don't prejudge anything. I don't look at so-called values, I look at price action. If they are going up, I buy them. And if they turn down, I sell them." It sounds simple and it is. The only difficulty is that the game has caught on and is being played by an unwieldy number of individuals and institutions. An individual with a few thousand shares in each crazily valued position can get out, but an institution with hundreds of thousands of shares in each position will not be so fortunate. As fast as stock markets go up, they always go down faster. And despite the many trading innovations that have recently been developed, it nevertheless remains difficult to push the proverbial elephant through a keyhole – when everyone wants to sell and there aren't many buyers.*
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> . . . Frederick E. "Shad" Rowe of Greenbrier Partners (*FORBES* – September 1991)

Indeed, the current mantra reigning on the Street of Dreams is – "I don't look at so-called values, I look at price action; if they are going up I buy them and if they turn down I sell them" – it sounds simple, and it is. The only difficulty is that game has caught on and is being played among an increasing community of professional players. This mindset can be seen by looking at the number of resources-based stocks ending with the letters "LF" making the Most Active and New High lists. However, such issues are typically "thin" (lacking volume), reminding me of a story I heard 40 years ago when I first arrived on Wall Street. The story was about a customer who called his broker with a hot stock tip. The customer proceeded to buy several thousand shares of the low-priced stock and saw it move up. The broker explained that the market was "thin" and consequently orders were hard to execute. Still, the customer persisted, ordering his broker to buy more and more stock, even as the price rose. Pleased that the stock was acting so well, the customer went "long" the shares with the last of his money, though with some difficulty because his bidding pushed the stock price even higher. Several days later the stock drifted down on light volume, traveling below the customer's last purchase and threatened to break below his average cost basis. In a panic, the customer called up and commanded, "Sell!" "To whom?" the broker asked. "Your buying has been the main factor in pushing the stock higher. There are not enough bids to get you out without breaking the stock substantially below your very first purchase!" So maybe the better title for this strategy report should read not "How High is High?" – but "To Whom?"

Ladies and gentlemen, there are a lot of people who think they can outperform the stock market, but only a small percentage who can actually do it. As Charles Ellis wrote, "Given the concept of a loser's game there are two ways in which you can do some good for yourself. One is to be smarter than the other guys, or work harder. The other is to not get caught up in excitements and depressions. Compose a long-term investment policy that is right for the market (and right for you), settle into it, and stay there forever."

To be sure, not getting caught up in excitements and depressions is key in this business. That said, it is a very difficult feat to accomplish. For example, it was October 10, 2008 when, after being pretty cautious coming into that year, I became bullish given that 93% of the stocks traded on the NYSE made new annual lows (on said date) for a new-low ratio not seen since "The Crash of 1987." Further, on March 2, 2009 I opined on numerous media venues that, "The bottoming process, which began in October 2008, is complete and we are ALL IN." At the time many investors thought I was a lunatic; however, from those March 2009 "lows" I have been consistently constructive, albeit at times with a modicum of cautionary comments for the ensuing short/intermediate-term corrections that have occurred along the way. Most recently, I turned cautious as we entered 2011, worried about a repeat of 2010. Recall, last year the major averages rallied 3.2% to start the year, right into their January 19th high, just before succumbing to nearly a 10% pullback. Moreover, there are a great number of similarities between the current stock market and the environment preceding the April 2010 market top.

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Of course, such comments illicit the question, "Hey Jeff, do you think we will get another 17% decline like we saw last May – June?" "Not really," has been my response because since 1940 there has never been more than one 10% (or more) correction in an ongoing bull market. And yes Virginia, according to Dow Theory this is a bull market. A fair question, however, would be "Is this a tactical, or a secular, bull market?" Personally I think it is tactical within the context of the broad trading range we have been experiencing since the turn of the century, but that's a discussion for another time. As the Lowry's organization writes:

> "In summary, just as at the April high, there are currently no indications a major top is forming. As to the extent of any short-term pullback, investors should monitor measures of short-term Supply for signs of a sharp increase. Also, the April top was quickly followed by a pair of 90% Downside Days. Similar intense selling after any near term market high would again suggest a deeper correction is possible, potentially the 5% - 7% range rather than a milder 3% - 5%. However, the probabilities argue strongly against anything approaching the April – August decline."

Therefore, I remain cautious in the short-term, but believe any pullback is for buying, begging the question, "Okay, so what do we buy?" Well given my mantra that 2011 may be the year of the banks, select bank stocks seem appropriate. Three names I have been using are: IBERIABANK Corp. (IBKC/$60.37); Peoples United Financial (PBCT/$14.42); and Huntington Bancshares Inc. (HBAN/$7.25). All three are currently rated Strong Buy by one of our Banking analysts here at Raymond James; please see their fundamental research for more details. I also think Technology is undervalued, as can be seen in the chart on page 3 from the good folks at Bespoke Investment Group. I have liked Technology since the 2009 stock market lows. Tech is also a second derivative play on emerging and frontier markets. Further, one of my tech themes has been efficiency, aka to make employees more productive via upgrading IT and management systems. As the brainy folks at GaveKal observe:

> "Overall, we think the consensus outlook on the enterprise refresh cycle is too conservative. There is no doubt the cycle disappointed last year. But this was partly due to product strategy uncertainty – some enterprises were uncertain whether to upgrade as part of an adoption of Windows 7, or switch to other systems, such as a looming cloud strategy. Moreover, last year's delays in planned upgrades corresponded with widespread fears that the recovery was unraveling; further confirmation that the economy is on track should increase corporate budgets. Despite the recent rally in markets, tech is currently trading at affordable prices. Tech PEs are at a discount to the five-year average PE across the broad – whether software, hardware, services, semiconductors, etc. Tech is also trading at a discount to the broad market despite strong cash management and profitability ratios."

The call for this week: The current buying stampede is legend with the DJIA experiencing no more than three consecutive days on the downside over the past 93 sessions. This, combined with numerous other negative indicators, continues to leave me cautious in the short-term on both stocks and commodities, but not bearish. As for buy ideas, as stated I do like Tech. Accordingly, tech names for your consideration on any pullback would include: CA Inc. (CA/$25.24/Strong Buy); Hewlett-Packard (HPQ/$46.25/Strong Buy); and NII Holdings (NIHD/$42.20/Strong Buy). And don't look now, but the iShares Muni Bond Fund ETF (MUB/$96.26) broke down in the charts last week to a new 52-week low (see the attendant chart on page 3), bolstering my feeling that you should be very careful about what fixed income vehicles you own.

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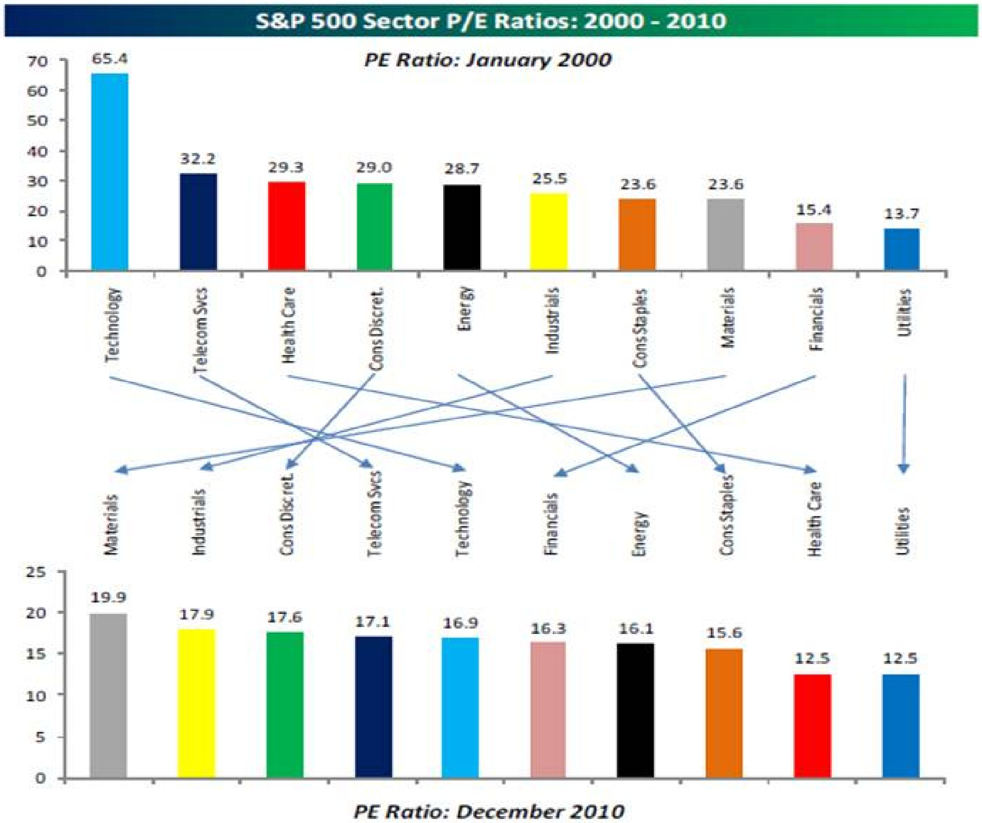

Source: Bespoke Investment Group.

iShares S&P National Municipal Bond Fund

Source: Thomson Reuters.

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