

INSIGHTS ON FRONT STREET



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WORTH A THOUSAND WORDS

NOVEMBER 2009

The most important factor in predicting future returns for the stock market is the price you've paid to get in. Granted, over the short-term, emotion wins out. However, over the longer-term, price acts like gravity. It inescapably alters the risk-return relationship.

This fact has led us to contemplate today's stock prices to judge the current force of this gravitational pull. The graphic below explains things much better than 1,000 words ever could. But, that could hardly stop me from writing a thousand words anyway!

Yale professor, Robert Shiller, developed a measurement tool that attempts to evaluate how cheap or expensive the stock market is based on the average of its past ten years of earnings. He chose a decade to smooth out the effects of normal business cycles and to negate the effect of accounting gimmicks that companies tend to play. His measure is naturally a long-term view.

The stock market, using this metric, historically trades at an average of 15 times earnings. Further, about 70% of the time the market trades between 10 and 20 times his earnings measure. It is now valued at 19 times.

For a brief moment back in March 2009 stocks were valued at about 13 times earnings. Notice how the lows hit during the recessions of '73 and '82 dipped below 10 times earnings. This,

along with other measures we look at, implied that stocks had another 25% downside potential at that time. You can imagine that we took this risk seriously then and we still do today.

However, after this huge rally, the market has already re-entered seriously overvalued territory. To have this happen in six short months is amazing. Perhaps investors are comforted that the market still sits 30% below its late 2007 high. We would caution that things only look cheap when compared with the extremely overvalued market just prior to the collapse. Relying on *relativity* is not a smart thing to do in investing.

Further, if you consider the abnormally high, finance-related profit margins earned during the recent '03 to '07 period, it raises the possibility that the current market's level of 19 times Shiller's earnings is actually an *understatement*. By "normalizing" the profit margins achieved during the housing bubble years, we could argue that stocks are priced for disappointment from current levels. A graph of these historical profit margins can be found online at www.frontstreet.com/charts.

For those interested, we've also posted two additional graphs online to illustrate why we believe people are bound to save more and whittle down their debt burden in the future. People have been burned during this recession and, like those who experienced the Great Depres-

sion, it will leave a few psychic scars. It is worth a look.

Glancing at our online charts will show how obvious it is that the last 25 years defied economic logic. It resulted in a huge credit bubble. And, credit busts usually take longer than only six months to heal. For those interested, read about how long it typically takes in Harvard professor Ken Rogoff's research piece, *The Aftermath of Financial Crises*. We've published his paper on our website as well. It goes without saying that we don't expect our current crisis to be the exception to the rule.

The only real question is how long the healing will take. As we've written before, our politicians and their appointed bureaucrats are working hard to smooth things out at a great cost.

Looking at the charts, savings rates have only just begun to rise and household debt levels have only just stopped rising. These ongoing

adjustments should be seen as long-term headwinds for any coming recovery.

Beyond the hard data, the more intuitive part of us sees things as being "just not right" on the horizon. We see money market rates of zero as a symptom, not a cure. We see the Fed's manipulation of longer-term interest rates as an attempt to prop up assets that might otherwise fall. We see the US Treasury spending and borrowing monumental sums of money and we worry about breaking the camel's back. And, unless we honestly want to test the strength of that camel's back, we see inevitable tax hikes on the horizon.

Our highly conservative portfolio stance, in light of these headwinds, places more weight on the negative consequences of certain scenarios. It's alarming how confident CNBC-type professional money managers seem in their ability to react nimbly in the future. We should all be aware that the astounding speed of this rally can work in reverse just as easily.

