

Living on a Prayer

November 10, 2008 Newsletter

Whoah, we're half way there

Whoah, livin' on a prayer

Take my hand, we'll make it - I swear

Whoah, livin' on a prayer

-Living on a Prayer - Jon Bon Jovi

Living on a Prayer Video

It is often said that “hope is a poor roadmap to success.” Hoping is as useful in investing as it is in nearly every other activity that I can think of. I must admit that I have found myself hoping that an investment or trade gone badly would come back. I must also admit that I cannot recall a time when I have been rewarded with success just because I hoped for it. That is also why I have learned to take losses when they are still manageable—as they say, “good traders know how to take gains, but great traders know how to take losses.”

I am not saying that I am a great trader, only that I recognize that admitting defeat when you are wrong about a trade or investment is the key to investing. Simply put, if I find myself wrong-sided, I “cut my losses and run”. Quickly. Better to lose 10% and have to earn 11% to get to break-even than losing 50% and needing to earn 100% just to get back to break-even.

If you think hoping is a poor roadmap to success, praying that your asset will magically come back in price is even more dangerous. This is the single biggest mistake being made

around the globe these days—“living on a prayer”.

What is Wrong with the Global Markets?

As equity and debt markets sink around the world, I am constantly bombarded by questions about why prices are falling. I could write pages and pages about why I believe prices have sunk so much and will continue to sink (not in a straight line of course) over the next couple of years. *Simply put, markets are sliding down the “slope of hope”*. Bull markets are said to climb up the “wall of worry” and, in direct contrast, bear markets slide the “slope of hope”. When investors give up on hope and capitulate to the point of despondency, enough fear has been placed into the system that the market can then climb the “wall of worry”.

The “slope of hope” has some easily identified characteristics; low cash levels in the mutual fund complex, low levels of short selling activity, and most importantly, a serious case of denial, or the “I don’t want to open my brokerage statement” syndrome. Another symptom of the slope of hope is that consultants and advisors that have been wrong-sided the whole way down will wish to stay the course as markets rise over the long-term, dollar cost average, etc. This sort of activity continues until the road to capitulation begins and fear takes over. With fear comes high cash levels, loads of short selling and a general disdain for stocks in general.

When I walk in to a bar or restaurant and see ESPN on rather than Bloomberg TV, Fox

Business News or CNBC, I know that we are getting closer to a bottom. When I see a bear on the cover of major financial publications, I will know that we are getting closer to a time to take risk again.

The main point I wish to make is that when earnings expectations have fallen enough that they are likely too low, then it will be hard to disappoint investors. ***The biggest problem in the markets at present is that earnings estimates are woefully too high. This is otherwise known as a “value trap”.***

As I sit in front of my Bloomberg terminal during the peak of earnings season for the S&P 500, I see a stream of earnings misses and lowered guidance. I have been around the industry for quite a while but the amount of misses/lower guidance seems more prominent now than at any other time that I can recall. So, from a “bottom up” or individual company standpoint, analysts and investors expectations are still way too high and they can only be disappointed, not pleasantly surprised as will often occur during bull markets.

In addition, my opinion, as it has been for several years, is that a perfect storm for earnings has formed—falling profit margins, debt destruction, deflation and a Credit Crisis, to boot. This applies to the Wall Street strategists and their “top down”, or index estimates, that have been falling like a rock—many of these strategists started with S&P 500 top-down earnings estimates north of \$100 per share for 2008/2009. With the S&P at 1200-1300, we were told that stocks were cheap relative to risk-less Treasuries.

I stated several months ago that I felt that stocks were still in a bubble ([Are Stocks Still in a Bubble?](#)) and that there were two problems with the \$100 per share estimate. First, I believed that the \$100 estimate was way too high, and secondly, Treasuries were the wrong asset to compare equities to. Arbitrarily picking the 10 year Treasury is as useful, to me anyway, as the price of tea in China. It is also

like comparing other risk instruments, namely corporate bonds, to Treasuries.

Instead, we compare them to riskless Ginnie Mae's with yields north of 6% (some specified pools can be had with yields close to 7%). While I no longer think that stocks are in a bubble, I still do not find them cheap compared to other investment options. When stocks yield 3%, and I am not comfortable that earnings estimates are correct, nor will they grow, I still find the “equity like” returns of Ginnie Mae's attractive.

For example, IBM recently came to market with a multi-billion dollar corporate bond deal that yielded approximately 400 basis points above comparable treasuries (never mind that IBM has historically been a very savvy issuer and has issued bonds just as spreads widen over Treasuries). I suppose if you live in a vacuum and consider the fact that IBM paper does look cheap on a historical basis vis-à-vis Treasuries, they do not look cheap versus risk-less (from a credit perspective) Ginnie Mae's and soon to be explicitly backed Fannie and Freddie paper.

Flawed Thinking

Let's say that you actually believe Wall Street's earnings estimates (guesses?). Further, let's assume that you have no idea how to buy Ginnie Mae, Fannie Mae or Freddie Mac paper or, for that matter, corporate bonds and that all you have to choose from are 10 year Treasuries and stocks. Since no one brings up the Fed Model much anymore, allow me to do so here and now.

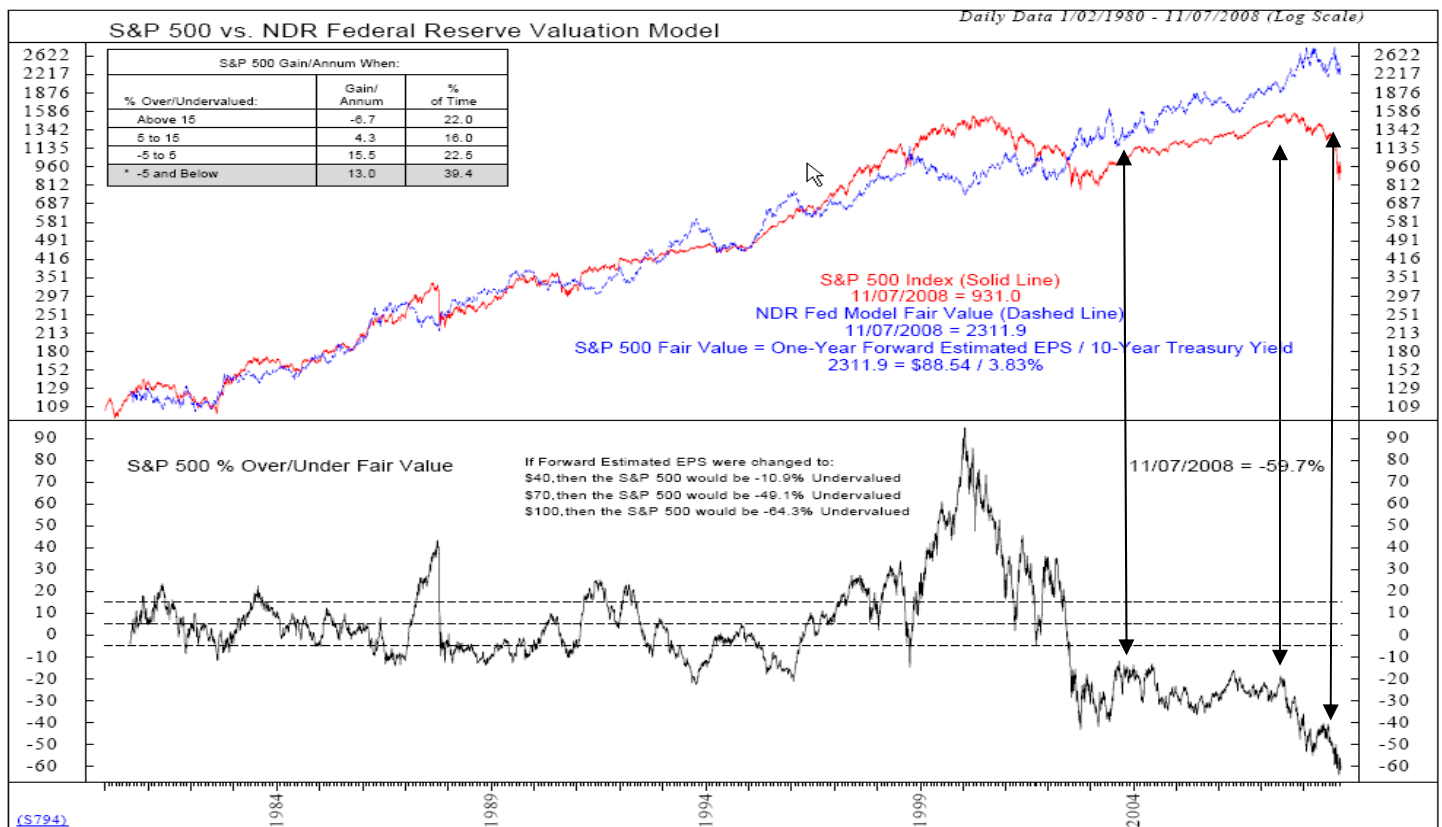
The Fed Model was developed to determine if stocks were “cheap” relative to 10 year treasury Notes. All you had to do was take the inverse of the yield of the 10 year Treasury note (the Price/Earnings ratio of the 10 year) and compare it to the Price/Earnings ratio of the S&P 500. When the P/E of the S&P was lower than the P/E of the 10 year, stocks were deemed to be “cheap”.

This flawed thinking worked very well from 1982-2000, a period of disinflation and the strongest secular bull market for stocks on record. The problem, of course, is that the only time this concept worked was during that time. If we go backwards in time to the 1950's and stocks traded at 7x earnings and Treasury yields were 3%, stocks would have been undervalued by 75%. Further, if we look at Japan's 1% rates, stocks would be cheap at anything under 100x earnings.

cheap for the past 6 years, a period when many have faced unprecedented volatility and made no money. What is most disconcerting is that this doesn't take into consideration how much money has been lost in the real estate market and the credit market. Sub-prime mortgage issues, now spreading to commercial real estate may end up dwarfing losses in equities. We are just now beginning to see the issues in the Alt-A and Option-ARM space. In other words, get ready for more pain, as if we haven't endured enough already.

In the chart of the Fed Model below, courtesy of Ned Davis Research, stocks have looked

Fed Model



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Worse yet, if you had listened to Wall Street's top down estimates a year ago (yes, the same bunch that completely missed the largest unwinding of credit and risk in history), stocks would have seemed cheap at 1500 with estimated earnings of \$100 per share. The math goes like this:

1500/100=estimated P/E of 15.

1/(10 year Treasury note Yield 4%) = 25.

We then apply the 25 P/E of the 10 year which equates to a "fair value" of the S&P of 2500. Flawed thinking at its best I would say. And not

only is it flawed, it fits the sell-side motive of selling all of this stuff to investors.

I do not take much credence from those on the Street that are permanently bullish nor bearish, but a dose of reality and absolute return thinking would go a long way to getting my

trust, and I am sure the trust of others (it isn't called the "Sell Side" for nothing).

All we must do is compare both the "bottom up estimate" of the S&P 500 to the actual reported top town number and we see a chasm as big as the Grand Canyon.



How can analysts, with all of their training, with all of the contact with management teams of public companies, be wrong so many years in a row? Why would anyone listen to this bogus, "buy the dip", "hold for the long term", "dollar cost average" philosophy? Better yet, why would anyone pay attention to the earnings estimates in the first place? They are nothing more than educated (I am being kind here) guesses.

So let's see, what would you rather own, a large group of stocks that you really have no idea what they will earn, or safe, highly liquid Agency securities? ***For now, but not for ever, I vote for the latter.*** Something has to give here; either the Fed model is flawed, the earnings estimates from Wall Street are wrong, or I am wrong.

Since I wake up every day expecting to be wrong, (as all risk managers should), should I

assume that what has saved me and many others from losses over the years is wrong? Or, should I assume that Wall Street is hopelessly optimistic, or that the model itself is flawed?

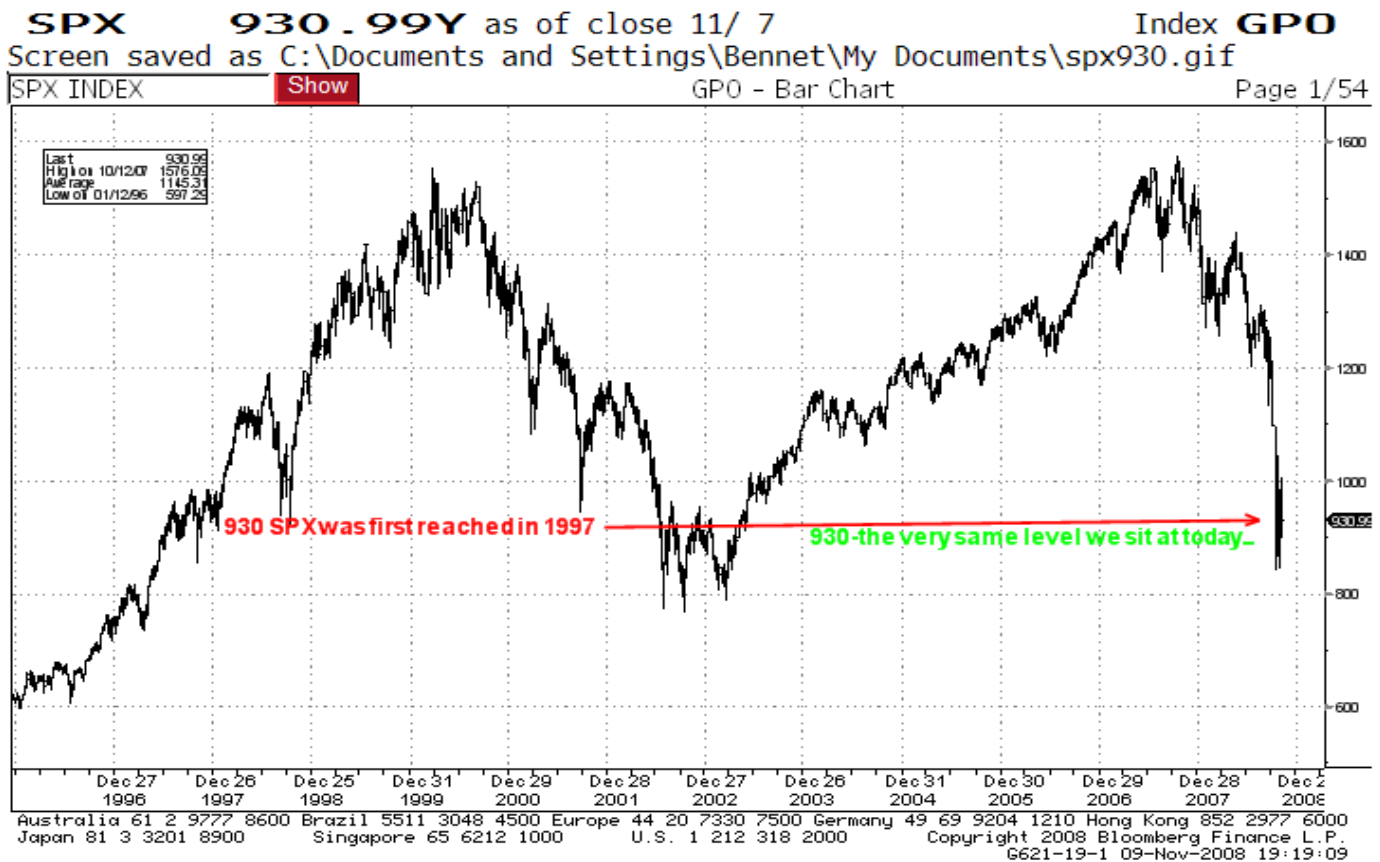
My vote, for what it is worth, is that a bit of all three is going on. I am wrong, at best, one-third of the time. The Street has been wrong, as best as I can tell, all of the time. The Fed Model is nothing more than a tool to get folks to invest on a premise that is at best flawed and, at worst, a mirage. Allow me to put it this way—if you had bought in to the "buy and hold" philosophy, the "dollar-cost-average-down" philosophy, the "stocks go up over the long-term" philosophy, you would have, since 1997, not made a nickel. You may have burned through what I like to call "emotional capital", but 11 years is a long time to go without making any money in one of your highest

expected return assets, without any consideration to opportunity cost.

The point that I am trying to get across is that those who try to understand the “Big Picture”, those that are willing to go out on a limb every so often, those that are willing to think outside the “MBA box” may be rewarded. Efficient market theory and the “Efficient Frontier” sound great, but I hate to break it to everyone, it is not market timing. It is a way to enhance returns while reducing volatility.

To be sure, it is a different kind of risk, a kind of risk that most are not willing to assume, and why I believe most investment managers and investors returns revert to the mean. Many academics will call this sort of approach “market timing”, which is fine by me. The fact is that if everyone is following the same model and studying the same courses from the same book, they are doomed to fail. Failure doesn’t necessarily equate to loss on an absolute return basis, rather it equates to capital invested in a risky asset class without proper compensation.

S&P 500 Chart



Summary-The Problem is the ‘E’

I will again assume that I am wrong, which is as I said, the way I wake up each morning. Waking up assuming you will be wrong is tough on one’s ego, but so be it, as long as it is the best course of action for those that entrust

assets to us. My issue is that given the unprecedented credit unwind, unprecedented Global Central bank intervention (as I write this, the G-20 is intervening as a team which will, in retrospect, I believe, be a fruitless operation), unprecedented debt levels, anyone that states that they have a good feeling what

earnings per share will be is, at best, taking a stab in the dark.

The sad truth is that the 'E' in 'P/E' is impossible to grasp in these unprecedented unwindings. Stocks may, or may not, look cheap 5 or 10 years from now. I hate to say that I do not know if they will on an absolute basis, but on a risk-weighted return basis versus risk-less assets, my hunch is that it will

not have been worth the risk over the next several years. As always, there will be pockets of opportunity, pockets that we will look to exploit.

Traditional, 'long only equity investing', over the next few years, in my view, is living on a hope and a prayer.

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