

Prepared Comments from 3/16/2009 Conference Call

My last conference call was on January 15th. Stocks had been falling for two weeks, after a strong late 2008 rebound. Stocks fell sharply between the last call and last Monday; then recovered just as sharply in the past week. Let's review the numbers.

The Markets

I focus on the S&P 500, rather than the Dow Jones Industrial Average. The S&P's index is broader, and a better reflection of the overall stock market.

The S&P ended August at 1283. It fell 41% by November 20th, when stocks appeared to hit bottom. Stocks recovered for the next five weeks, and by year end were 20% above their November lows. That gain evaporated, as stocks fell 9% in January and 11% in February, and then fell another 8% in the first six business days of March, leaving US stocks 10% below their November lows, and 47% below their August close.

In the past week, US stocks have rebounded, rising 11%, and are about equal to their November lows, but are still 41% lower than their levels in August.

The Economy

The US economy is shrinking, and is expected to continue to shrink. Unemployment has risen, and is expected to continue to rise. Fed Chairman Ben Bernanke and the Federal Reserve governors, and a set of economists recently surveyed by the Wall Street Journal expect the economy to stop shrinking by year-end. (Note that these are the same folks who did not foresee this recession, so take their predictions with an appropriate grain of salt.) The reason that economists expect the recession to end by roughly the year end is that there has been tremendous stimulus introduced and to-be-introduced into the US and foreign economies. While this doesn't solve problems overnight, in time it takes hold and yields positive results.

The stimulus includes rescue and stimulus legislation passed by Congress, lowering the Fed Funds rate to near zero, significant purchases of mortgage bonds by the Fed, and a sharp decline in oil prices from their summer peaks. These sources of economic stimulus have been mirrored world-wide, to address the recession which spread world-wide.

How will we know that the economy is ready to grow again? We need to have our banking system working again. The financial industry is the economy's circulatory system—the body can't function if the blood is not pumping through the arteries and veins. This means that individuals need to be able to get a car loan, and that a business needs to be able to get a small business loan. Individuals need to be able to get a mortgage and a home equity loan, if they qualify, and the qualifications must be reasonable.

I will keep an eye on housing, to see that sales are increasing and inventory (the number of unsold homes) is starting to decline. Beware the headlines. Often housing figures are released with comparisons to the figures from a year ago. I don't care how February 2009 home sales and inventory figures compare to February 2008; I care how they compare with January 2009. I'll look for a slowing pace of deterioration, and a leveling off of the housing numbers. That will indicate that we are about to emerge on the other side of this nightmare.

The Stock Markets and the Economy

Warren Buffett, in his latest annual report, states: "We're certain, for example, that the economy will be in shambles throughout 2009 – and, for that matter, probably well beyond – but that conclusion does not tell us whether the stock market will rise or fall."

I have always said that stock prices (and stock market levels) move based on two factors—economics and emotions. Furthermore, there is most often a time lag—stocks generally move (up or down) before the economy moves (up or down).

Stocks have risen by 11% in the past week. Is this due to economic news? Not really. Yes, Citigroup claims that they actually made money in the first two months of 2009. Does that justify the entire market jumping 11%? Not by itself.

Two months ago I stressed that stock markets move mostly based on unexpected economic surprises. If, as of today, unemployment is expected to rise to 9% within six months, then if it rises to 9% within six months, this wouldn't be news, and it shouldn't result in stocks moving up or down. If, however, it rises to 10%, or stays at 8%, that would be unexpected, and stocks would likely react to that development.

I contend that earlier this month, as was the case in late November, an incredible amount of negative expectations was built into the stock markets. When this is the case, it is hard to

encounter a negative surprise (a development worse than you already feared), and this often accompanies a stock market bottom.

Stocks are Cheap

Several days ago I looked at Procter and Gamble, a well known company, and the fifth largest stock in the US market. From its recent peak in September, its stock price had fallen 40%. You would therefore expect that this was accompanied by the expectation that its 2009 earnings would be much lower than in 2008, due to the obvious challenges of operating in a shrinking US and world economy. In fact, its 2009 and 2010 earnings are expected to climb 17% or more versus 2008. A lot of babies have been thrown out with the stock market bathwater in the past six months. As though the case needs to be strengthened, Procter & Gamble is paying a 3.5% annual dividend.

Procter & Gamble is not the exception. By most measures, stocks are cheaper than they have been for decades. Buffett described GEICO's opportunities: "Tony and I feel like two hungry mosquitoes in a nudist camp. Juicy targets are everywhere." In the past, when they got to this level, future returns turned out to be much greater than normal.

Remember that you are not deciding how to avoid the 2008 and early 2009 bear market. That train has left the station long ago. You are deciding how to invest for the rest of 2009, 2010, and beyond.

Emotions and Investing

I have written about this in past newsletters. Investors are cursed, by being human. Built into our brains is an area called the amygdala. It encourages us to run when faced with a sabre tooth tiger, and to sell when stocks fall. Suze Orman, in her latest book, writes "The biggest risk in your retirement security is giving in to your emotions. When fear and doubt are in control, you may make decisions that feel "right" for 2009, but they will hurt your long-term retirement strategy."

Buffett writes, "When investing, pessimism is your friend, euphoria the enemy." And later "The market value of the bonds and stocks that we continue to hold suffered a significant

decline along with the general market. This does not bother Charlie or me... Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."

Opportunities

I consider bonds to be more interesting than stocks at this time. The reason is that stocks appear uniformly underpriced at this time: large stocks, small stocks, US stocks, and foreign stocks alike. I continue to prefer to strike reasonable balances (roughly 2/3rd of stocks invested in the US, and 2/3rd of stocks invested in larger companies), however I feel that stocks are all 'on sale.'

Bonds provide a more diverse roster. Treasuries are quite overpriced. Buffett notes that "Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long." Corporate bonds seem properly priced at this time, and provide yields of 6% or so. Corporate high yield bonds are yielding 15-20%, due to investors fleeing this sector. At the current yields, they appear to more than compensate investors for the obvious risk of defaults, and they appear to offer future returns close to stocks - with lower downside risk. Municipal bonds are Ok at this time. Their yields are much higher than Treasuries, but that is because Treasuries yield absurdly low levels of interest. Muni's carry a risk of defaults, given the weak economy and the fact that municipalities can't simply print money, the way the US government can.

Firewall Investing

For my clients, I have always stressed the portfolio's allocation, how much is directed to cash and bonds, and how much is in stocks. In times of bad stock markets, you should carefully consider what you have in cash and bonds. How many years worth of withdrawals can it cover? In a typical case, a recent retiree withdraws 5% annually, and has a portfolio with 40% in cash/bonds and that overall produces 2% in dividends and interest. He/she will therefore need to take 3% of 'principal' from the account annually, and the 40% in cash/bonds will last more than a dozen years. I have yet to hear of anyone who feels that the economy, and the markets, will not recover in over a dozen years.

As long as the retiree stands firm and refuses to sell any stocks/stock funds, the 2008/2009 losses will be only paper losses, more than earned back over time.

No one knows when stocks will launch a reliable recovery—it may have begun last week. If you were all in cash last week, you missed the opportunity to earn 11% in five days. My point is that you don't need to know when stocks will recover. You need to know that your cash and bonds, the money that is behind your firewall, is enough to cover your needs for a few years (preferably more than five). If so, you can afford to hold onto your battered stocks, and you should be better off for exercising this patience.

Downsides and Decisions

The economic future is about as cloudy as it has been in a long time, at least since the immediate aftermath of the 9/11 terrorist attacks. It is highly unlikely that we will proceed down a smooth path of a 'slowing slowdown' followed by a steady recovery. Elements of the economy can turn out worse than we are currently fearing. One of the most significant long-term concerns is how the economy can regain its growth rate when consumers no longer have the benefit of using home equity to drive their consumption. (The second significant long-term concern is whether the global stimulus will lead to future inflation.) I take both of these concerns seriously, however I feel that the first is fully reflected in the current stock market values, and the second is highly unlikely to be a concern for at least two years.

My overall point is that investors have a choice. You can put money in a money market earning 1% or so, with essentially no risk of loss. You can invest in Treasuries with a similar yield, with a likelihood of losing some of your money. Investors can choose to wait for 'clear signs' of a recovery, and miss out on rallies such as the past week's 11% gain.

Your alternative is to hold onto your stocks and stock funds, representing companies whose prices have fallen 40%, and which are paying dividends much greater than money markets. I prefer that we eliminate the risk and stress of trying to time the stock market's recovery, deliberately set the value that is behind your firewall, and invest the rest in the knocked-down stock markets, where you are literally paid (dividends) to await recovering stock prices.