



**American Trust
Investment Advisors**

PERSPECTIVES

A Wall of Worry

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There is an old stock market adage that says markets often *climb a wall of worry*. That is to say, the market often performs better when anxiety levels are high, rather than low. There is a plausible rationale for why this might be so – namely that if there are many worries bedeviling investors, such concerns will already be reflected in lower stock prices. Lower prices are, all else being equal, a better place to purchase or hold stocks than at higher prices. As worries fade, stocks typically advance. When there is nary a worry to concern oneself with – watch out below! So the theory goes.

By this way of thinking, investors should be immensely reassured in today's environment. Sure, there are certainly plenty of things to worry about. Top of mind, these worries might include the Euro zone crisis, the oil spill in the Gulf of Mexico, Iran, tension on the Korean peninsula and in the Middle East, a subpar recovery in the US economy, and a mountain of U.S. national debt, to name but a few. But amidst all of the doom and gloom, and likely because of it, there is one unalloyed, compelling and critically important consideration for investors: Stocks are cheap again!

True, the S&P 500 is still up almost 60% from the market low set in March, 2009. But year-to-date we have seen stock market declines of 5% in the U.S., close to 10% in Europe, and 15-20% in emerging markets such as Brazil and China. Meanwhile, corporate earnings are expected to grow by 25-30% in the U.S. and Europe, and by over 30% in a number of emerging market stock markets. The disconnect between stock prices and earnings means that the price-to-earnings ratio, or P/E ratio, has come down markedly for most stocks through both a lower price, and via higher earnings.

The U.S. market overall now sells for under 13x forecast 2010 earnings, and under 11x 2011 earnings. The P/E ratio for Europe stands at just over 10x forecast earnings for the next twelve months, and the emerging markets are also valued at just over 10x for the same period. These are very reasonable valuation levels for equities, and a good entry point for new funds to be put to work in the market. How reasonable are these valuations? For the U.S. market, by the most common valuation metrics, current valuations stand 1 to 2 standard deviations below their ten year history. This is quite inexpensive.

As to the “wall of worry” that began this newsletter, although many believe that it pays to worry, the truth is that what really pays is to take action with respect to one's worries – and then worry no longer. We were reminded of this wisdom by no less an authoritative source than the government's latest payroll figures. While the unemployment rate at May 31st stood at an unpalatable 9.7% overall, the differences in unemployment rate by level of education is stark: a stunning 15.0% for those with no high school diploma; an abysmal 10.9% for high school grads with no college; a better 8.3% for those with some college but

less than a Bachelor's degree and only 4.7% for college graduates. Our takeaway for young people: Don't spend your time worrying; spend your time hitting the books!

Our other takeaway from the above, for *less* young people (we count ourselves in that number), is that the unemployment rate in this country is indeed worrisome. Including discouraged workers, the rate of unemployment is over 16% overall and for those without the benefit of education it is far, far worse. We take some solace by recognizing that unemployment is a lagging indicator of the economy, and that the payroll data from our current jobless recovery tracks very closely to what was seen in the jobless recoveries of 1991 and 2001.

While the latest U.S. payroll report was glum, there is much evidence to support the view that we really are in a global economic recovery. Whether very strong German factory orders, four quarters of robust U.S. productivity measures or booming economies in China and Brazil, there is a palpable and rather ruddy recovery in much of the world. Manufacturing, in particular, is very strong. And there is even evidence that there is hope yet for employment. The U.K.'s leading temporary employment company, Manpower, released a global survey of hiring intentions on June 8th that is highly encouraging. Companies in 30 out of 36 countries show a greater intention to add workers versus one year ago, and in 23 countries there is a greater intention than 3 months ago.

What have we done in light of market volatility and economic uncertainty? In May we initiated a number of changes to portfolios to benefit from what we believe is an excellent opportunity to purchase "cyclical growth" companies. These are companies whose shares have been adversely impacted by fear of a double dip recession but whose long term prospects suggest a future that should benefit not only from economic recovery but also from long term growth potential. Examples include Owens Corning, Boeing, Martin Marietta Materials, Plum Creek Timber and VF Corporation. All of these are world class companies in their respective fields, with excellent management teams, strong balance sheets, favorable cash flow characteristics and compelling valuations. When the cyclical winds turn, we expect their performance could be outsized relative to the overall market.

We also continue to emphasize exposure to the more rapidly growing emerging markets. We accomplish this three ways: 1) through purchase of a select few companies that are solely in emerging markets; 2) through ownership of multinationals with emerging market exposure; and 3) through ownership of energy and materials companies that benefit from rising consumption in these areas of the world.

A final note, on *confidence*, from tennis great Stan Smith (are we dating ourselves?): "Experience tells you what to do; confidence allows you to do it". While times continue to be uncertain and market volatility tests investor risk tolerance, we have very strong **confidence** in the companies in which we invest, in their growth potential and in our own internal investment discipline, the last of these based on our experience. We would be delighted to share with you the reasons for our confidence, and the rationale for any of the investments in your portfolio. Please feel free to call us anytime, and we hope that you take some time to enjoy the summer months.

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