



All the King's Horses...

It's no time for nursery rhymes, but the fumbling efforts of the world's leaders to right the sinking economies of the developed world had us thinking of nothing so much as Humpty Dumpty. Like the futile efforts of all the king's horses and all his men – we are increasingly of the view that the fragile economy may not be repaired, or even repairable, through the efforts of policymakers. We shared with you some of our concerns in our August newsletter. This follow-up expands and updates those concerns, and more importantly explains the thinking behind the actions we have taken in recent days to protect your portfolio.

As is always the case in investing, the greatest difficulty comes in understanding what is already expected, and therefore already reflected, in the prices of securities. Most of you have witnessed the head-scratching phenomenon of a company that announces an enormous increase in profits – only to see its stock decline after the announcement. It isn't that the profits did not go up, it is just that the expectation was that they would go up even more than they did. So too for the stock market as a whole, which gives rise to the phenomenon of stocks slumping *ahead* of a recession, and almost invariably rising well *before* the recession ends.

So we face the usual tension, between bad news that is already expected by the stock market, versus the bad news that is not yet reflected, and the possibility for good news. These have all been factors in our decision-making. So, here is a summary of our thinking – the good, the bad and the ugly:

The Good: First, stocks are cheap. That is the single biggest “risk” to some of the reduced exposure to stocks that we have undertaken for your portfolios – namely that we may miss some of the upside from a stock market recovery when it comes. In fact, we reckon that the upside inherent in the stocks that we own broadly throughout our client portfolios is on average over 40% at the time of this writing (*). We are loath to sell stocks – believing that there is substantial value in the shares of the companies that we own. On the other hand, the apparent bargain inherent in the stock market today may prove to be ephemeral to the extent that earnings do not pan out as expected. Indeed, the stock market has been ahead of the game here, while analysts who forecast earnings have been slow to reflect a slowing economy in their estimates of what companies can earn.

Further supporting the case for owning stocks is their attractive dividend yield – averaging 2.2%, which is about the same as 10-year Treasury notes. This is a very rare circumstance, as 10-year Treasuries have almost always yielded much more than stocks.

(*) assuming a “normal” economic environment, i.e. that we avoid a recession.





Lastly, in certain respects, one could take comfort from the headlines. The problems facing the economies of the developed world, the U.S., Europe and Japan, have been decades in the making. The fact that policymakers are now in high gear as they tackle the crisis suggests that we are finally doing something to address these problems. Depending on your view of the efficacy of policymakers in this country and abroad, this could be soothing, or not (more on the latter below).

The Bad: As for us, we do believe that the efforts of the Europeans will be successful enough to save the Euro and stave off a banking crisis, at least in the short term. In the U.S., the efforts of the Congressional “Super Committee” will likely yield some compromise resulting in further deficit reduction. But we do not believe that such efforts, either here or in Europe, can alone contain the rising probability of recession. Some of these efforts, such as cutting government spending, could actually worsen the economy in the near term. And the odds are that such a recession, if it comes, will be global in nature – albeit tempered a bit in some of the emerging market economies.

The Ugly: As if “the Bad” were not bad enough, it could be worse. In retrospect, the efforts of policymakers in 2008- 2009 were successful. After badly miscalculating by letting Lehman Brothers fail, a potential depression was averted through the concerted efforts of the US Treasury and the Federal Reserve. Today, the U.S. is in relatively better shape than Europe. Our banks have been recapitalized. And while the economy is listless, it was rescued from the depths of the free fall witnessed in 2008-2009. Europe will not miscalculate and allow a major financial institution to fail – having well learnt the lessons of Lehman Brothers. But a recapitalization of its banks will be a messy affair, and potentially even destabilizing. The apportionment of losses between shareholders, taxpayers, creditors and borrowers will almost certainly be ugly, and at worst debilitating to confidence. A strong contractionary “freeze” in business confidence could ensue – resulting in a deep recession, as opposed to a garden variety one.

With the good, the bad and the ugly in mind, let us proceed, reluctantly perhaps, to a look at the stock market. Despite all of its volatility recently, the stock market is still up over 90% from the lows of March 9, 2009. So we still have plenty to protect. The stock market has yet to recover to the levels seen in 2007, which by some definitions would suggest that we are still in a prolonged bear market. Notwithstanding that definition, the 110% recovery off the March 2009 lows through April would be a bull market to rival most any other on the record books. Let’s put semantics aside as we think about valuation and risk.

More recently, an interim stock market high was reached this year in April, when the S&P 500 hit a level of 1364. At a recent level of 1225, we are 10% off from that near term high. If we are indeed moving into a period of recession, it is worth considering recent stock market cycles in thinking about potential downside. In the table below we show a number of methods for thinking about downside. The simplest (#1 below) is to look at the average cycle decline in a bear market, which is -32%. By that measure alone, we would have a little over 20% to go.



There are a number of “multiple” based methods (see #2 and #3 below) that come up with mostly less downside (particularly #3). A dividend based approach (#4 below) shows a much larger potential downside, but we discount this approach as less relevant given the large impact of the financial sector, whose current low payouts constrain the dividend yield relative to history. Thus we would argue this measure is non-representative of a typical cycle. The average of all of these methodologies is a further 20%+ decline, which would put us at 937 on the S&P 500. Think of it this way: **If we are entering a typical bear market, we are probably one third of the way toward the trough of the market. It is not too late to act, but important not to overreact.**

The importance of not over-reacting is borne out by the history of bear market troughs. In the bear markets cited below, the S&P 500 rallied an average of 15% in the first three months after the trough. And a large part of this rebound occurred in the first four weeks.

Four Different Methods to Consider Potential Bear Market Trough Levels			
		Current S&P 500 Index Level:	1225
		@ April 2011 market peak:	1364
(Excluding 2008-2009 bear market)			
Methodology	Average Cycle	Current Cycle	Implied Trough based on History
1. Average decline based on 9 bear markets since 1957	-32%	-10%	928
2. Multiple Contraction since 1970			
Trailing P/E	-36%	-20%	977
Forward P/E	-33%	-17%	988
Realized Forward P/E	-31%	-7%	906
Price/Book	-35%	-17%	909
3. Discount to 5-yr Average P/E	19%	7%	1064
4. Change in Dividend Yield	68%	8%	788
	AVERAGE		937
Source: Average Cycle data and methodology from GS. Current Cycle and Implied Trough based on ATIA calculations.			



We will not be overly reliant on this statistical approach, but it gives us a sense of how prior market behavior might play out today. We find these measures to be informative in assessing potential risk. They may also prove quite helpful in gauging potential opportunity, given that we have moved to insure a meaningful cash reserve in our client portfolios – which we intend to reinvest.

We recently came across an interesting quote in a book we were reading about time management that struck us as being very relevant to money management, as well. This quote is from Ancient China's I Ching text, said to be as much as 4,000 years old. The I Ching is from before the time of Confucius, who in fact wrote commentaries about it. The following excerpt might well be the oldest argument ever made against the perils of market timing:

Just as the tumultuous chaos of a thunderstorm brings a nurturing rain that allows life to flourish, so too in human affairs times of advancement are preceded by times of disorder. Success comes to those who can weather the storm.

The key is being in a position to weather the storm – financially as well as psychologically. This means being comfortable staying in the market with our now lower stock allocation, knowing that we intend to reinvest, and acting on that plan accordingly. Perhaps we will regret a lower allocation to equities, and perhaps we will not have the wisdom or the courage to reinvest at the most favorable time. Indeed, it is quite unlikely that we will do so at *the most* favorable moment. But we do believe that we have reduced our equity allocations at a relatively good time, and we are preparing for a potential correction – and the potential opportunity that may ensue.

We hope that we are wrong about a further market decline. If so, we will be modestly disappointed that we did not have a higher exposure to stocks in a rising stock market environment. On the other hand, if our “bad” or “ugly” scenarios play out as discussed above, we will at least have the comfort of knowing that our actions made a difference in protecting the long term value of your assets, and ours, during a difficult period.

Please don't hesitate to call with any questions or concerns that you may have. We look forward to speaking with you in the near future.

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