The Long & Short of It

Quarterly Newsletter
Third Quarter 2011

The growing realization that Greece will not heal itself set the tone for the third quarter of 2011. Despite the Federal Reserve's low interest rate policy that encourages risk taking, investors moved away from risk, by selling equities (particularly international and small cap stocks) and buying bonds (especially US Treasuries). "Wait a minute," you say, "US Treasuries for safety…really?" To our amazement --in defiance of the national balance sheet, the budget, and Washington's inability to manage them-- US treasuries remain, in the eyes of many, a safer alternative than other investments.

In the greater scheme of the global economy, Greece's gross domestic product (GDP) is approximately the same as the GDP of the Dallas/Fort Worth Metroplex. The pall over Wall Street is not simply the prospect of Greek default, but more the realization that the lack of political will to get one's fiscal house in order is not just a Greek or European problem but also an American problem.

The travails of our world's political economy are well known. The public dignitaries of the industrialized world continue to get paid but cannot fix what they broke. Although, emerging economies remain a source of hope, their success remains contingent on the ongoing purchasing power of the industrialized world.

As the 1990's bubble of optimism reversed during the 2000's, the hope and expectation that "the post war expansion" would return has been replaced by the realization that debts must be paid down or forgiven and commitments reduced, leaving a loss of confidence in its wake. Bad policy decisions and bad actors have left investors convinced that our world will only get worse. Regularly, we hear the drum beat: the US is in decline, buy and hold is dead, stocks and Wall Street are broken. In an obvious contradiction, large publicly traded companies are simultaneously loathed for making rapacious profits and shunned by investors for being so bloated and over-regulated that they cannot compete.

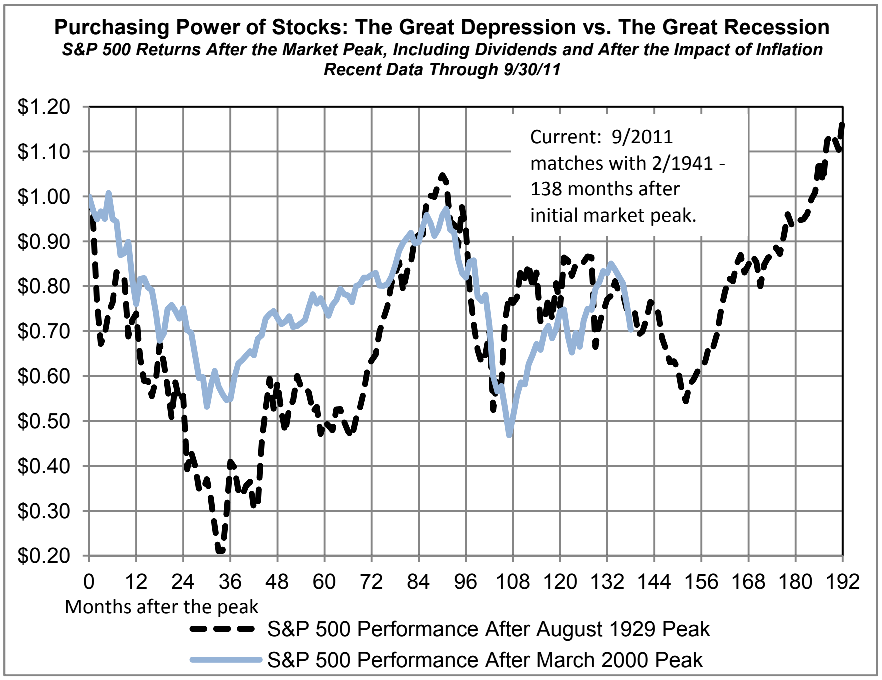
But take note….the current pessimistic environment is consistent with other historic moments of opportunity for stocks when long term bottoms were made.

For the last 11.5 years, investors have received insignificant returns from large publicly traded stocks. From the March 31, 2000 market peak at the end of a two-decade-long bull market, to the September 30, 2011 end of this quarter, the S&P 500 returned an annualized -0.6%, the DJIA +2.4%, and the NASDAQ -5.4%. These returns include the impact of dividends and fail to keep up with the 2.6% rise in the Consumer Price Index.

During the same 11.5 years, these companies' fundamental measures of value have continued to improve as median per share measures of book value, sales, earnings, cash flow, and dividends *each* grew by annualized rates between 6% and 8%. This means that these significant fundamentals have more than doubled over the last 10 years, while stock prices went nowhere to slightly down. As a result, for example, P/E ratios around 20x-30x in early 2000 have dropped to the low teens today, well below historic averages.

Beyond the fundamentals, another source of encouragement is the fact that large publicly traded companies have stable businesses, providing most of the products and services each of us enjoys-

-a fact that is unlikely to change. We use their products and services because these companies provide them better and cheaper than anyone else can. In addition, many of these publicly traded companies effectively have embedded venture capital funds with the best expertise in the industry, often purchasing smaller firms with innovative ideas to integrate into their own operations and built-in client base. Moreover, publicly traded equities are usually the first to price in gloom and the first to reflect the gloom lifting.



The press would have investors believe that the bad times are just beginning; however, the stock market has been digesting this slower growth reality for nearly 12 years. The accompanying chart depicts the purchasing power of a dollar invested in the S&P 500 (i.e., the total return, including dividends, minus the impact of inflation). The time periods undergoing comparison are those of the Great Depression (peak in August 1929) and the Great Recession (peak in March 2000). We are now 138 months past the market peak preceding the Great Recession and equity investors are no better off than they were 138 months after the peak preceding the Great Depression. What is particularly striking is the similarity in the rhythm of the rises and falls during these two periods. If the Great Depression serves as a guide --with a bottom in early 1942 150 months after the 1929 stock market peak-- the time between now and the November 2012 election will be challenging. Sometime between now and then lows would be reached that would represent some of the best buying opportunities in anyone's lifetime.

In the 1940 election, Franklin Roosevelt defeated Republican businessman Wendell Willkie through strong support from labor unions, big-city political machines, ethnic voters, and the traditionally Democratic Solid South. Republicans made significant gains in Congress but the Democrats maintained the majority. The stock market bottom was made in the spring of 1942 with midterm elections to come in November, where the Republicans gained a few more seats but the Democratic majority was never threatened. In the presidential election of 1944, with World War II still ongoing, Roosevelt won a fourth term.

Comparisons can only take us so far; after all, it is not 1942. A presidential election is not the same as a midterm election. The two deflationary periods are not the same. But the market bottom happened without any major change in party control or significant progress in the war. The bottom came a year before Montgomery took Tripoli and the Germans surrendered at Stalingrad (the first big defeat of Hitler's army).

So, recall that a stock market does not reflect the present but rather expectations for the future, discounted with assumed interest rates that rise with the presumption of uncertainty. As growth expectations drop and uncertainty about the future rises, we have two factors working together to create a major league low and the worst of all worlds for stock pricing. Providing an opportunity for investors who persevere, the stock market will eventually discount an unrealistic, excessively pessimistic and uncertain view of the future. The best pricing for domestic equities will come when we collectively feel our absolute worst and see the dimmest light at the end of the “Things Will Get Better” tunnel.

However, long term political and economic improvement can only begin in earnest after the moment of recognition—when both voters and politicians admit there is a problem and find agreement as to what it is. Much of what is required to reach that goal has already passed. Most Americans would agree there is a problem. The debate has moved to finding consensus as to what the problem is and what to do about it. Equity prices may have more downside ahead, but fundamentals and valuations would indicate that the downside is significantly limited. Equities will lead the way to solid returns as fiscal and regulatory uncertainty begins to abate. The wealth of each nation increases unevenly through time as the pendulum swings between the mechanisms of wealth creation (what some would call “capitalism”) and wealth distribution (what some would call “socialism”). Fortunately, the challenges faced by the US come primarily from within. They are ours to solve. It would be nice --before we reach the miserable state in which Greece finds itself—if the electorate could give our leaders the political cover they need to do the right thing and place the general interest above special interests.

For our part, we see vulnerability in the paper currency system, so that means one can make non-productive assets (gold, antiques, art, jewelry) a larger portion of one’s net worth than usual. It also means a larger allocation to gold mining stocks in our portfolios, something that has been helpful for the last decade. As for more productive assets than collectibles (those that generate cash flow to their owners), we see a bond bubble that may or may not bust, but has little remaining upside. Real estate remains in a correction or base-building mode. For large publicly traded stocks, the list is long: very strong balance sheets, low multiples, declining expectations, over a decade of underperformance relative to other investments, and palpable uncertainty about the future. For us, as contrarians, the icing on the cake is the growth of a faction that appears to loath large corporations and free enterprise in general. Either we have reached the end of the world, or things are beginning to set up pretty well. We do not make bets on the end of the world, so we will take the position that big cap domestic stocks offer something unique and elusive these days—a reason to be optimistic. Whether the bottom comes in October 2011 or waits for the uncertainty surrounding the next election to pass, we believe a major low will soon be made in stocks—one that will be looked at five, ten, and twenty years hence as an opportunity on par with that of early 1942.

Charles W. Robinson III, CFA

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